No. 10

Supreme Court, U.S.
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OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

FREEDOM HOLDINGS, INC., INTERNATIONAL TOBACCO PARTNERS, LTD., on behalf of themselves and all others similarly situated,

Petitioners,

—v.—

ANDREW M. CUOMO, in his official capacity as Attorney General of the State of New York, ROBERT L. MEGNA, in his official capacity as Commissioner of Taxation and Finance of the State of New York,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

In 1998, 46 Settling States acting in their proprietary capacity entered into a Master Settlement Agreement (the "MSA") with the four major cigarette producers having 98% of the U.S. market (the "Majors" or Original Participating Manufacturers—"OPMs"). The agreement settled all product liabilities claims those States had or ever would have against the Majors. To fund the settlement, the parties agreed to set up an output cartel in the MSA whereby the Settling States covenanted to the Majors that they would eliminate competition with them in those States by enacting and enforcing identical State statutes penalizing the output of the competitors not participating in the MSA (the "Non-Participating Manufacturers"—"NPMs"), thereby enabling the Majors to overcharge consumers of cigarettes billions of dollars annually and split these supra-competitive revenues with the Settling States. That continues to this day and this action seeks to stop it.

The questions presented are:

1. Does the elimination of NPM competition within the Settling States achieved by enforcing identical statutes throughout those States penalizing the output of NPMs and resulting in higher cigarette prices nationwide violate the dormant Commerce Clause, Article I, § 8, cl. 3, U.S. Constitution?

2. Does Section 1 of the Sherman Act, 15 U.S.C. § 1, preempt the implementation of the coordinated enforcement of identical state statutes implementing the output cartel?

3. Should the judicially created doctrine of State action immunity provide antitrust immunity for the collaborative enforcement by the Settling States of statutes penalizing the output of NPMs so that cigarette consumers can be overcharged billions of dollars annually?

PARTIES TO THE PROCEEDINGS BELOW

Petitioners, Freedom Holdings, Inc. and International Tobacco Partners are importers of cigarettes not made by companies belonging to the MSA and are defined in the MSA as Non-Participating Manufacturers ("NPMs"). They were the plaintiffs in the district court and the appellants in the Second Circuit. Neither petitioner is publicly traded or owned, in whole or in part, by any publicly traded entity.

Respondent Andrew M. Cuomo was the Attorney General of the State of New York until December 31, 2010, and Robert L. Megna was the Commissioner of Taxation and Finance of the State of New York. They were both sued in their official capacities as defendants in the district court and were the appellees in the Second Circuit.

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GLOSSARY OF TERMS AND ACRONYMS

Allocable Share Release: The Allocable Share Provision of the Escrow Statute, MSA Exh. T at 4, mandated a release to the NPMs of their escrow payments in excess of what any Settling State receives to the extent that those funds exceed the amount the State would have received from that NPM as its allocable share of MSA Base Annual Payment if that NPM had been an SPM.

Allocable Share Release Repealers: Statutes that have passed in all of the Settling States except Missouri, whereby NPMs are no longer entitled to a refund of the portion of their annual escrow payment that exceeds the proportion of the allocable share payment due to the state in which the escrow payment was made.

Contraband Statutes: Statutes subsequently enacted in all the Settling States except Kansas and Missouri. They provide for forfeiture of the state tax stamping license of any wholesaler that sells cigarettes made by Non-Participating Manufacturers on which escrow funds have not been paid.

Enforcement Statutes: The ***Escrow Statute***, the ***Contraband Statute*** and the ***Allocable Share Release Repealers***.

Escrow Statute(s): Statutes enacted in all ***Settling States*** that require ***Non-Participating Manufacturers*** to make payments into escrow on all cigarette sales made in the Settling States.

The MSA sets forth a model Escrow Statute for each Settling State to enact. *See* MSA Ex. T. As

originally enacted, the Escrow Statute contained the ***Allocable Share Release*** provision. However, ***Allocable Share Release Repealers*** have been enacted in and all Settling States except Missouri.

Freedom Holdings I: *Freedom Holdings, Inc. v. Spitzer*, 357 F.3d 205 (2d Cir. 2004) (reversing trial court's dismissal of plaintiffs-appellants' claims under the Sherman Act).

Freedom Holdings II: *Freedom Holdings, Inc. v. Spitzer*, 363 F.3d 149 (2d Cir. 2004) (denying defendants-appellees' motion for rehearing of *Freedom Holdings I*).

Freedom Holdings III: *Freedom Holdings v. Spitzer*, 447 F. Supp. 2d 230 (S.D.N.Y. 2004) (denying in part and granting in part plaintiffs-appellants' motion for a preliminary injunction).

Freedom Holdings IV: *Freedom Holdings v. Spitzer*, 2004 WL 2251668 (S.D.N.Y. Oct. 6, 2004) (denying plaintiffs-appellants' motion for reconsideration of *Freedom Holdings III*).

Freedom Holdings V: *Freedom Holdings v. Spitzer*, 408 F.3d 112 (2d Cir. 2005) (affirming denial of preliminary injunction).

Freedom Holdings VI: *Freedom Holdings v. Spitzer*, 592 F.Supp. 2d 684 (S.D.N.Y. 2009) (granting final judgment under Fed. R. Civ. P. 52 to defendants-appellees and dismissing plaintiffs-appellants' claims under the Sherman Act and dormant Commerce Clause).

Freedom Holdings VII: *Freedom Holdings v. Cuomo*, 624 F.3d 38 (2d Cir. 2010) (affirming *Freedom Holdings VI*).

Grandfathered SPMs ("GFSPMs"): They are ***Subsequent Participating Manufacturers*** that joined the ***Master Settlement Agreement*** within 90 days of its original execution. Grandfathered SPMs receive an exemption under MSA § IX(i) from MSA annual payments on cigarette sales below the greater of (i) 100% of its 1998 market share or (ii) 125% of its 1997 market share.

Master Settlement Agreement ("MSA"): The agreement executed on November 23, 1998, between the four ***Original Participating Manufacturers*** and the ***Settling States*** to settle lawsuits brought by the Settling States to recover damages related to treating smoking-related illnesses. Subsequent to its execution, other manufacturers have joined the MSA—***Subsequent Participating Manufacturers***. The MSA, *inter alia*, requires annual payments by the Original Participating Manufacturers and by Subsequent Participating Manufacturers to the Settling States and releases them from product liability claims by the Settling States.

Model Escrow Statute: The MSA § IX(d) requires the Settling States to enact Escrow Statutes in language substantially identical to that contained in this Model Statute, annexed to the MSA as Exhibit T.

National Association of Attorneys General ("NAAG"): The trade association consisting of the attorneys general of the fifty states charged with enforcing the MSA under § VII and § VIII therein.

Non-grandfathered SPMs ("NGFSPMs"): Non-grandfathered SPMs are ***Subsequent Participating Manufacturers*** that joined the ***Master Settlement Agreement*** *after* 90 days of its original execution. *See* MSA § IX(i)(1) & (4).

Non-Participating Manufacturer ("NPM"): A cigarette manufacturer or importer that is not a party to the ***Master Settlement Agreement***.

NPM Adjustment: A downward adjustment to each base annual payments made by the ***Participating Manufacturers*** to the ***Settling States*** if (i) the Participating Manufacturers in the aggregate lose more than two percentage points of market share compared to 1997, (ii) an independent consulting firm retained by the parties to the ***MSA*** determines that the MSA was "a significant factor contributing to" that market share loss, and (iii) is to be paid by any Settling State determined to have "diligently enforced" its Escrow Statute. MSA § IX(d)(1)(A) and (C).

Original Participating Manufacturers ("OPMs"): The four largest cigarette companies that entered into the ***Master Settlement Agreement*** with the ***Settling States***.

Previously Settled States ("PSS"): The four states—Florida, Mississippi, Minnesota, and Texas —that, having reached separate settlements with the ***Original Participating Manufacturers*** prior to the execution of the ***Master Settlement Agreement***, are not signatories to it.

Settling States: All of the States except the four PSS plus six geo-political territories are party to the ***Master Settlement Agreement***. MSA § II(qq).

Subsequent Participating Manufacturers ("SPMs"): Industry signatories to the ***Master Settlement Agreement*** that are not ***Original Participating Manufacturers***. The payment obligations of a Subsequent Participating Manufacturer depends on whether it joined before or after 90 days of the execution of the Master Settlement Agreement. *See also* Grandfathered SPMs and Non-grandfathered SPMs.

Volume Adjustment: A provision of the Master Settlement Agreement that reduces ***Participating Manufacturers'*** annual payments to the ***Settling States*** if the "Actual Volume" of sales by ***Original Participating Manufacturers*** is below the Original Participating Manufacturers' sales in 1997. *See* MSA Ex. E.

PETITION FOR WRIT OF CERTIORARI

Petitioners respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit.

OPINIONS BELOW

The Opinion granting final judgment after trial on the merits against the petitioners by the District Court for the Southern District of New York is published at 592 F. Supp.2d 684 (S.D.N.Y. 2009) and is attached hereto as Appendix B1-B49 and is sometimes referred to herein as *Freedom Holdings VI* (*"FH VI"*). The Opinion of the Second Circuit affirming the district court is published at 624 F.3d 38 and is attached as Appendix A1-A62 and is sometimes referred to herein as *Freedom Holdings VII* (*"FH VII"*).[1]

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[1] The following citations refer to Court of Appeals and District Court decisions in this action. These are *Freedom Holdings v. Spitzer*, 357 F.3d 205 (2d Cir. 2004) (*"FH I"*), holding that the enforcement of State statutes penalizing the output of NPMs by eliminating their competition, if proved, at trial would state a valid claim under Section 1 of the Sherman Act, 15 U.S.C. § 1. It also held the affirmative defense to that claim of state action immunity was insufficient as a matter of law. *Freedom Holdings v. Spitzer*, 363 F.3d 149 (2d Cir. 2004) (*"FH II"*), denying a petition for rehearing by the defendants of the ruling in *FH I*, and again holding that the affirmative defense of State action immunity was insufficient as a matter of law. *FH VI* and *FH VII* essentially overruled *Freedom Holdings I* and *Freedom Holdings II*. *Freedom Holdings v. Spitzer*, 447 F. Supp.2d 230 (S.D.N.Y. 2004) (*"FH III"*), denying a motion for preliminary injunction against enforcement of the statutory output

JURISDICTION

The Second Circuit issued its decision on October 18, 2010 and denied a petition for rehearing *en banc* on December 17, 2010. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1). The district court had subject matter jurisdiction under 28 U.S.C. § 1331.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause, U.S. Const., Art. I, § 8, cl.3, provides, in relevant part:

> The Congress shall have the Power. . . To regulate commerce . . . among the several States. . . .

This affirmative grant of authority to Congress encompasses an implicit or "dormant" limitation on the authority of the States to enact legislation affecting interstate commerce. *See e.g., Healy v. The Beer Institute*, 491 U.S. 324, 326, n.1 (1989).

Section 1 of the Sherman Act, 15 U.S.C. § 1, provides, in relevant part:

> Every contract, combination. . .or conspiracy, in restraint of trade or commerce

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penalties with the exception of issuing one against enforcement of the Allocable Share Release Repealer imposing statutory penalties on NPMs in addition to those originally set up in the MSA. *Freedom Holdings v. Spitzer*, 2004 WL 2251668 (S.D.N Y. Oct 6, 2004) (*FH IV*), denying defendants' motion to vacate the preliminary injunction restraining defendants from enforcing the Allowable Share Release Repealer. *FH VI* vacated that preliminary injunction.

among the several States . . . is declared to be illegal.

STATEMENT OF THE CASE

Evolution of the Master Settlement Agreement

Starting in the mid-1990s, a number of States filed subrogation claims against the OPMs, seeking to recover healthcare costs allegedly expended for illnesses associated with smoking. Typically, these suits alleged that over several decades the OPMs engaged in fraudulent and deceptive practices causing the States to incur such healthcare costs. Every such case that was finally adjudicated was dismissed as a matter of law.[2] Nevertheless, in 1997 the OPMs and the States sought to use these suits and potential claims for creating a congressionally approved output cartel with all of the States. They applied to Congress for approval of a "settlement agreement," the Global Settlement Agreement ("GSA") containing essentially the same type of output restraints subsequently embodied in the MSA. *See FH I*, 357 F.3d at 210-11; *FH II*, 363 F.3d at 151. The proposed GSA is available at http://www.cnn.com/us/9705/tobacco/docs/proposal.html.

The proposed GSA required annual payments by the Majors to the States about twice as much as those called for in the MSA—about $15 billion per year,[3] GSA Title VI(B). In evaluating the GSA for

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[2] *See, e g , Steamfitters Local Union, No 42, Welfare Fund v Philip Morris, Inc* , 171 F 3d 912 (3d Cir 1999)

[3] By contrast, under the MSA, assuming the OPMs' losing little market share to competitors, they will pay to

Congress, the Federal Trade Commission ("FTC") estimated that the OPMs could finance the entire $368.5 billion national settlement by raising prices to the consumer during a 25-year span by a total rise of about 60¢ per pack.[4]

The 1997 GSA would have restrained competition by smaller competitors, NPMs, by imposing substantial per pack penalties on their sales, thus protecting the market share from the OPMs. It was the model for the output penalties on NPMs ultimately embodied in the MSA's Model Escrow Statute, MSA § IX(d)(2), MSA Exh. T. An NPM would have been required to pay a penalty based on 150% of its assigned market share, GSA Title III(C), thus creating an output cartel, but legalized through Congressional approval.

The cornerstone of this failed 1997 GSA was its provision for an exemption from the antitrust laws for the OPMs, GSA App. IV(C)(2). In September 1997, the FTC opposed this proposed exemption. It condemned the output cartel of the GSA as a vehicle for generating supracompetitive revenues for the OPMs with no supervision over their pricing. In the October 1997 Senate hearing, FTC Chairman Pitofsky objected to the excessive profits the OPMs would make:

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these states about $177 billion over a 25-year period—an annual average of about $7 billion/year (MSA §§ IX(a), (b) and (c)), or roughly half of what the States would have received under the GSA. The text of the MSA and its exhibits are available at http //www.naag.org/backpages/naag/tobacco/msa/msa-pdf

[4] Even though the MSA annual payments are only half of this $15 billion, the OPMs have now raised wholesale prices from about $15 per carton pre-MSA to about $27 per carton—or 85% *See infra*, pp 14-15.

> The analysis contained in the FTC Staff Report demonstrates that approximately two-thirds of any additional revenues generated as a result of increased industry coordination will go to the manufacturers as excess profits.

Chairman Pitofsky pointed out that the "antitrust exemption could permit firms to raise cigarette prices beyond the level necessary to satisfy payments under the settlement, resulting in a windfall to the industry." The GSA was not reported out of the Senate Committee. Undeterred, the Majors then turned this defeat at the federal level into a far more lucrative victory for them at the state level by getting the Settling States to enter the MSA. As discussed below, the output penalties statutes imposed on NPM sales protect and engorge these revenues—the same effect that doomed the GSA—but the Settling States receive substantially less than the GSA would have provided.

The Operating Results of the MSA

The MSA has achieved the objective of an output cartel: supracompetitive profits from supracompetitive revenues based on abnormally high prices on increasingly lower sales made by the cartel members.[5] The following chart shows its

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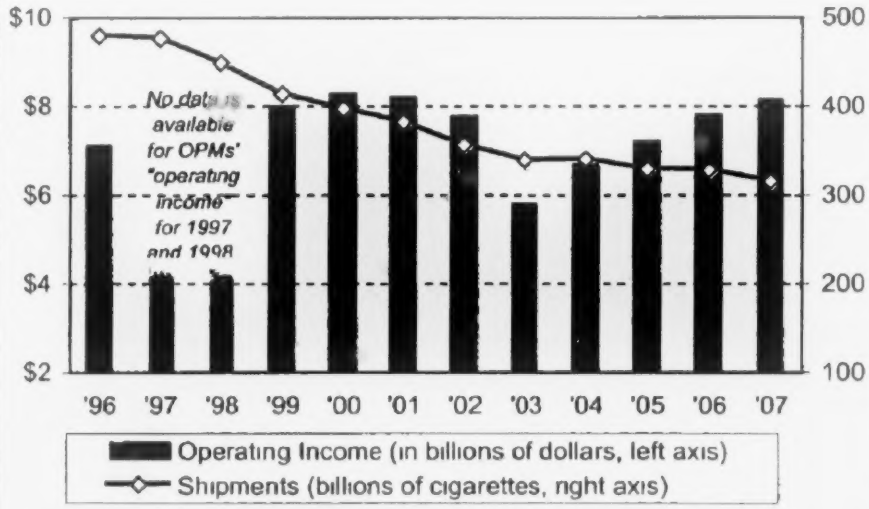
[5] Under FTC/Department of Justice guidelines, output restrictions are classified as "*per se* illegal" and thus "hard core cartel agreements" because they are designed to and, if enforced, do result in supracompetitive prices *FTC/DOJ Guidelines—for Collaborations Among Competitors*, 4 Trade Reg Rep (CCH) ¶ 20,855 (2000) Historically they have been the subject of criminal prosecutions *See FH I*, 357 F 3d

success: The substantial increase in the operating income of the OPMs, after deduction of all MSA payments, coupled with the declining volumes of cigarettes.

OPMs' Operating Income and Shipments
1999-2007



The sales and income data reflected in all of the charts as well as in the text herein are contained in the record on appeal in this action.

The decline in an OPM operating income during the 2002-2004 period as shown in the foregoing chart *supra* at p. 6, came about because the amount of statutory output penalties imposed upon the NPMs was insufficient to restrain their

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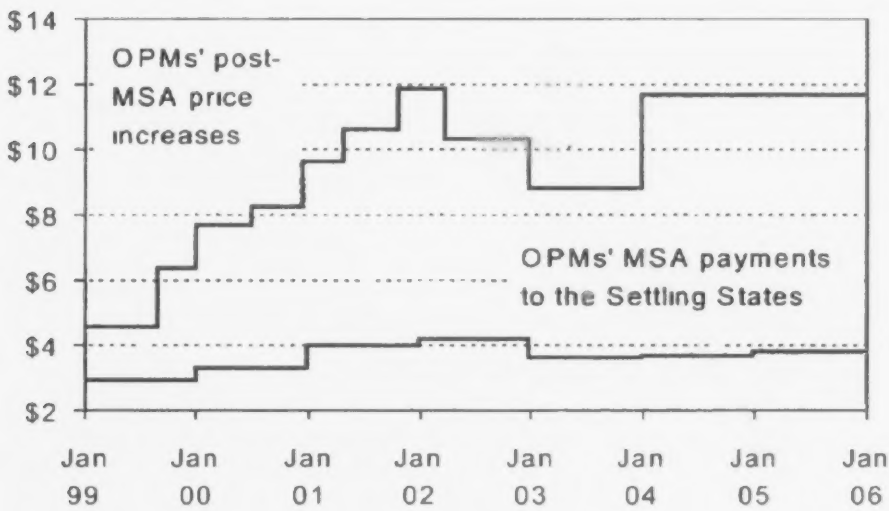
at 226. Both *FH I* at 226 and *A D Bedell Wholesale Co v. Philip Morris, Inc* , 263 F 3d 239, 247-248 (3d Cir 2001), *cert den* 532 U S. 1081 (2002), held that these statutory output restraints mandated by the MSA constituted an output cartel As Judge Posner observed in *General Leaseways, Inc v. Nat'l Truck Leasing Ass'n* , 744 F 2d 588, 594-95 (7th Cir 1984), output cartels are the flip side of prices fixes

competition in light of the supracompetitive price rises made by the OPMs. In 2002, the Counsel of State Governments ("CSG"), composed of all of the Settling States, issued a report concluding that the increase in NPMs' market share post-MSA was caused by the supracompetitive post-MSA price increases that created the differential between the prices for premium cigarettes made by the Majors and the deep discount cigarettes made by the NPMs of about $17 per carton. (Joint Appendix on Appeal at A506; A570). The following chart displays the chronology of these price rises and the share of those price rises received by the Settling States:

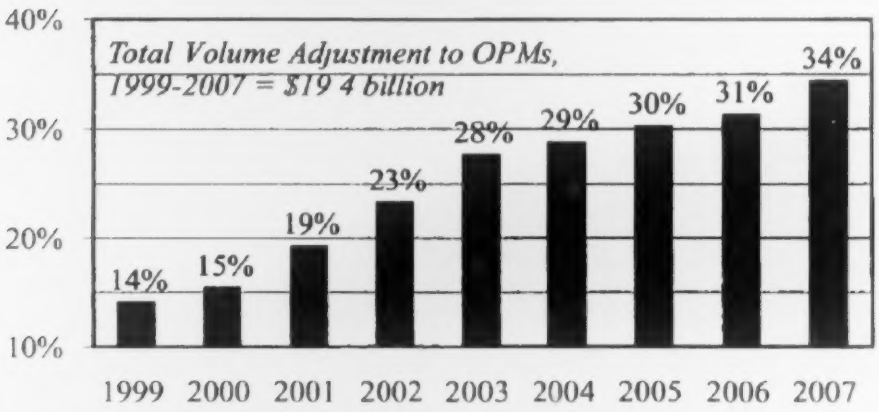
History of OPMs' Price Rises (per carton)
1999-2005



As shown by the foregoing chart, *supra*, p 7, the OPMs retained three times as much money on a per carton basis of these post-MSA price rises as do the Settling States—$9.00 for the OPMs com-

pared to $3.00 for the Settling States. This threefold price differential is accomplished primarily by the Volume Adjustment in the MSA. MSA § IX(c)(2). The MSA does not peg the OPMs' payments to the Settling States to dollar volume but rather to physical volume. Thus, as the trial court recognized, "it rewards decreasing sales and punishes increases." *FH III*, 447 F. Supp. 2d at 257.

Rebates to OPMs of MSA Annual Payments Due to Volume Adjustments (MSA Exh. E)



Source: PWC Notice IDs 0076, 0160, 0191, 0215, 0241, 0243, 0245, 0247, 0249

As the foregoing chart shows, the OPMs are in fact rewarded for these price rises by paying less and less of the fixed annual payments set forth in the MSA, MSA § IX(c)(2), as their sales decrease.

The Escrow Statutes: The Statutory Penalty On NPM Output

The parties to the MSA recognized that they could not force NPMs into making per-carton payments to the settlement fund as was provided in the failed GSA. Only Congress, not the individual

States, had the constitutional power to force NPMs to pay into the settlement. Thus the States agreed with the OPMs that they would promptly enact and "diligently enforce" identical output NPM penalty statutes, the Model Escrow Statutes, requiring the NPMs to make per-carton payments—"escrow payments" on their sales—substantially equivalent to what an SPM would pay annually on such sales to the Settling States if they were competing nationally. MSA § 1x(d)(2)(B). There is no taking, at least in the legal sense, because title to these escrow funds remains with the NPMs. *See Star Scientific, Inc. v. Beales*, 278 F.3d 339 (4th Cir.),*cert. denied*, 537 U.S. 818 (2002). The escrow fund is set up on a revolving basis with an NPM not getting its first refund for 25 years. All of the Settling States enacted this Escrow Statute in identical terms. *FH VII* at 43, A7.

The parties to the MSA sought to obviate the dormant Commerce Clause and Compact Clause infirmities inherent in conscripting the NPMs into the MSA as *de facto* SPMs by forcing them to pay these escrow penalties on their sales of cigarettes. They did so by inserting into the Escrow Statute the Allocable Share Release provision (the "ASR"). MSA Exh. T. It provided a refund to an NPM of its escrow payments made to a Setting State in excess of what that State would have received from that NPM as its allocable share of an MSA Base Annual Payment if it had been a Subsequent Participating Manufacturer ("SPM"). For example, New York State receives about 12.5% of the national base annual payment that a Participating Manufacturer pays as its full payment based upon its national sales. MSA Exh. A. Thus, if an

NPM made all of its sales in New York, under the ASR, as originally enacted, it would only have to pay into the New York escrow fund 12.5% of the full escrow payment, 12.5% being the allocable share New York receives of any national base annual payment made by any Participating Manufacturer. MSA, Exh. A. If it made 50% of its sales in New York State, it would receive a rebate of 37.5% of its escrow funds, *i.e.* 50%-12.5%. Thus, to maximize these rebates, NPMs concentrated their sales in a few States.

In a memo to the attorney generals of the Settling States commenting on the CSG report discussed *supra* at p. 7, the chairman of NAAG's Tobacco Committee[6] likewise attributed the loss of OPMs' volume, and the NPMs' market gains to the OPMs' inordinate price increases:

> [T]he [CSG] Report correctly notes the massive increase in the price of cigarettes since 1997.... In fact, the major cigarette manufacturers raised prices by several multiples of their MSA costs.... The price increase that created the market opportunity for NPMs is not attributable to the MSA, but rather to the decision by the OPMs to inflate per-pack profit margins at the cost of losing market share. (Joint Appendix on Appeal A532).

The MSA annual payments to the States are geared to OPM volume. MSA II(c). This inevitable increase in NPMs' market share caused by the

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[6] In ¶ VIII of the MSA, the Settling States agreed to delegate the "coordination and facilitation for the implementation and enforcement" of the MSA to the National Association of Attorneys General ("NAAG").

OPMs' large price increases caused substantial reductions in MSA payments that the Settling States were receiving as a result of the shrinking volume of OPM sales. Thus, by 2002, the Settling States were under great pressure to throttle NPM sales.

The Start Of The Allocable Share Release Repealer Campaign In 2003

As a result of the OPM rampant price rises in 1999-2002, the NPMs' volume in the Settling States rose, see chart *infra*, p. 14, and the OPMs' volume dropped with the MSA annual payments to the Settling States decreasing because these payments are tied to volume.

Consequently, in late 2002, the Settling States threw their constitutional concerns to the winds about conscripting the NPMs into the MSA as *de facto* Subsequent Participating Manufacturer ("SPMs").[7] NAAG drafted and circulated to the Settling States the "Model Amendment" to the

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[7] As appears from the table in *FH VI* at 691, B14, the table of escrow payments set up in the Model Statute, MSA Exh. T, is computed so that the full escrow fund payment, after factoring in the Inflation Adjustment Factor, is always a few cents lower than the full SPM annual national payment for any given year. The documented, undisputed proof is that in making escrow payments nearly as large as those of non-grandfathered SPM annual payments, SPMs, like NPMs, simply cannot compete. *FH VI* at 692, B15.

There are two classes of small competitors that joined the MSA after it was formed in late 1998: 1) Grandfathered SPMS ("GFSPMs") that got a bonus for joining prior to March 1, 1999 – no MSA annual payments on sales less than what they sold in 1998, and 2) those that did not – Non-Grandfathered SPMs ("NGFSPMs").

ASR provision of State Escrow Statutes. The Amendment eliminated per carton refunds that were not the excess of what an NPM would nationally make into the Base Annual Payment if it had been a NGSPM. Because the full national escrow fund payment was set in the MSA, MSA Exh. T, to be always slightly less than what a NGSPM pays, this threshold can never be reached. Thus, the Amendment to the Allocable Share Release in effect repealed with no ASR refunds payable in those states that enacted it, and virtually all of them did.

Starting in 2003, NAAG conducted its campaign to repeal the ASR on behalf of the Settling States, and it began to pay dividends even in that year. In his memo of September 12, 2003, the Chairman of the NAAG Tobacco Project, established under MSA, § VIII, urged the AGs of the Settling States to complete their collaborative efforts to enact the ASR Repealers, thereby throttling the NPMs. He explained:

> It should be stressed that NPM sales anywhere in the country hurt all States. All payment calculations are done on the basis of cigarette sales nationally. NPM sales in any state reduce payments to every other State. All States have an interest in reducing NPM sales in every State.

By September 2004, approximately 30 of the Settling States had enacted it, *FH III*, 447 F. Supp. 2d at 256, and all but one (Missouri) have now done so. *FH VI*, 592 F. Supp. 2d at 703, B39.

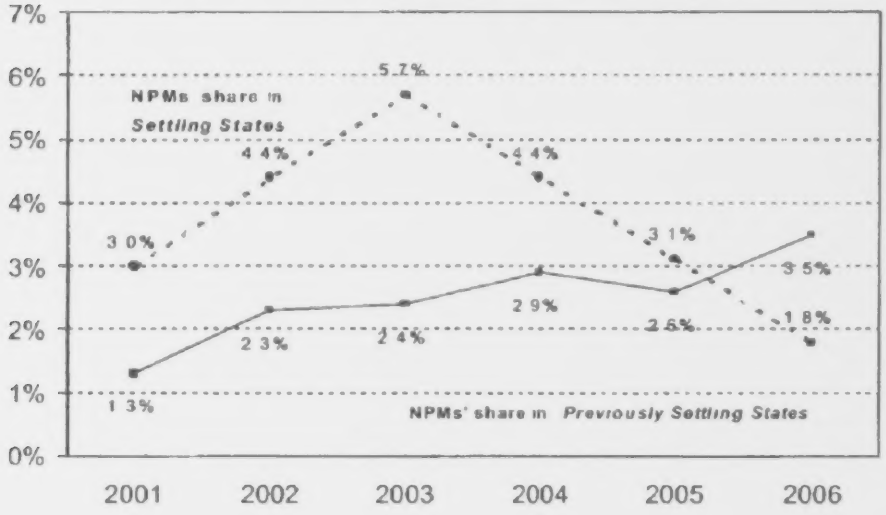
The trial court recognized that "[t]he provisions of the MSA motivating State action, MSA Art. IX

and the pressures imposed by the OPMs in light of their declining profits" appeared to be the motivating factor for this quick and widespread enactment of the ASR Repealer. *FH IV*, 2004 WL 2251668, at *1.

The Previously Settled States Reduction

After Congress rejected the GSA in 1997, the first step the Majors took towards achieving a multi-State agreement with the restraints that were ultimately built into the MSA was to make individual settlements with the four Previously Settled States ("PSS"), Florida, Minnesota, Mississippi, and Texas. None of these settlement agreements the OPMs made with the four PSS contained statutory penalties on the output of NPMs. That is why as a group, the NPMs in the PSS have been able to compete successfully. The following chart reveals the progressive elimination of NPM competition in the Settling States and increase in NPM market share in the PSS starting in 2003 as the increased output penalties became enacted throughout the Settling States.

NPMs' Market Share in Previously Setting States vs. Settling States, 2001-2006 (per State Excise Tax data)



To summarize, the anticompetitive results of enforcing these statutory output penalties in the 46 Settling States may be summarized as follows:

1. The virtual elimination of NPM sales within the Settling States as they began to suffer the heavy output penalties imposed by those States, following the repeals of the ASR.

2. With the increase in these statutory penalties on NPMs, starting in 2004 the OPMs restored all of their supracompetitive price rises post-MSA and regained their substantial loss of market share. See chart supra, p. 7; *FH VI* at 691, B14.

3. As a result of these price rises and elimination of NPM competition in the Settling States, starting in 2004 the OPMs restored their supracompetitive operating income

first achieved in 1999 and did so on ever declining sales volume—the hallmark of a successful output cartel.

4. Because of these price rises, the Settling States' annual MSA payments still continue to shrink, even though NPM competition was being eliminated.

The Renegade Clause

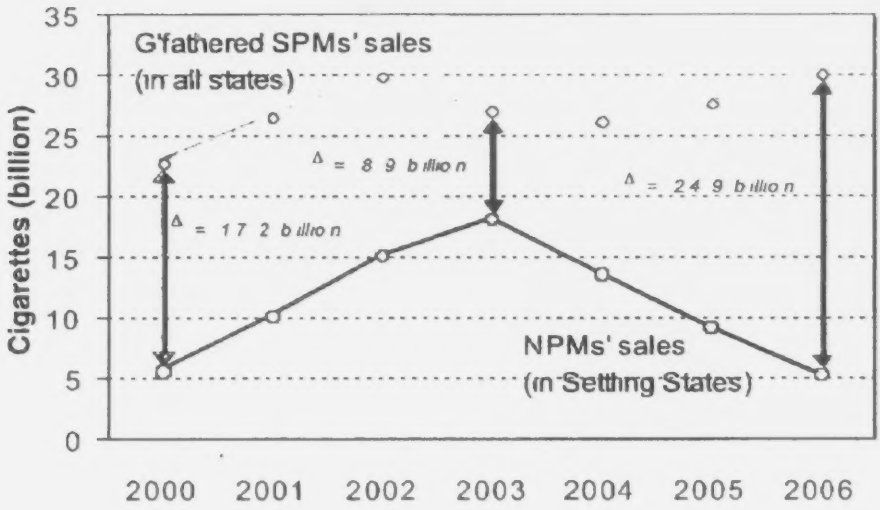
A vital issue in setting up the MSA was what to do about the manufacturers that were not the targets of the states' lawsuits and other small competitors that might enter the market post-MSA and capture significant market share from the OPMs because of the supracompetitive prices that they would charge. The OPMs insisted on this mechanism for forcing the small manufacturers to join the MSA or penalizing those that did not, thereby ensuring the smooth functioning of the cartel: the Renegade Clause. This clause provides that any small manufacturer joining the MSA prior to March 31, 1999 makes no per-carton annual payments to the Settling States on sales of those cigarettes that did not exceed its 1998 market share or 125% of its 1997 market share, whichever was greater. Thus, as long as it sells below that market threshold, it owes nothing to the Settling States. (MSA § IX(i)(1)); *FH VII* at 43, A6. Most of the small manufacturers existing when the MSA was made in late 1990 quickly fell into line and entered into the MSA as Grandfathered SPMs ("GFSPMs").

The Grandfathered SPMs: The Engine For Suppressing NPM Competition

The Renegade Clause serves a two-fold purpose for the OPMs. It penalizes the sales of GFSPMs that are substantially in excess of their grandfathered quotas because doing so puts them at a substantial competitive disadvantage. Most importantly, for purposes of this case, it functions as a powerful tool for suppressing the NPMs in the deep discount market. That is the only market segment where the NPMs sell. The GFSPMs are able to eliminate NPM competition in the Settling States because the statutory penalty payments on output the NPMs make are about 90% more than the per carton MSA annual payments the GFSPMs made. See *FH VI*, 592 F.Supp. 2d at 697, B24; Table 1, B14.

As shown by the following chart, they were able to compete with the NPMs selling regionally through 2003 on fairly equal terms, and then with the increasing enactment and enforcement of the ASR Repealers starting in 2003, the grandfathered SPMs substantially eliminated the NPM sales in the Settling States.

NPMs' Sales Versus Grandfathered SPMs' Sales 2000-2006



The NPM Adjustment: The Tool For Victimizing The Settling States

In drafting into the MSA, the Majors insisted upon a mechanism for forcing the Settling States to perform their covenant of enacting and enforcing the "Model Statutes" into the Escrow Statutes, penalizing the output of the NPMs. MSA § IX(a)(B). That mechanism is the NPM Adjustment, MSA § IX(d)(2)&(3). It provides that in any year that the Majors suffer a "Market Share Loss," they get to deduct treble the amount of the Market Share Loss if "a recognized firm of economic consultants" determines in a hearing that the loss was the result of the provisions of the MSA being "a significant factor" causing it. They then recover the treble damage award against those States that did not "diligently" enforce the penalties on the NPMs. MSA § IX(d)(1)(c); *FH VII* at 43, A6.

Starting in 1999, most of the Settling States in their efforts to prove their "diligent" enforcement quickly enacted the Contraband Statutes. *FH I* at 213; *FH VII* at 43, A9. These statutes provide for the forfeiture of the stamping license for any wholesaler selling NPM cigarettes on which escrow funds were not paid. In urging the New York legislature to enact the Contraband Statute, then Governor Pataki stressed the dire nature of this threat. *See FH I*, 357 F.3d at 213. Also, the relatively fast enactment and enforcement of the ASR Repealers discussed above were due in no small part to the enforcement by the Majors of this NPM Adjustment.

In 2003 the Settling States paid the Participating Manufacturers $1.7 billion to settle the NPM Adjustment proceedings brought by the OPMs seeking rebates from the Base Annual MSA Payments for 1999-2001 sales. For such annual payments for 2003-2005 sales, the MSA has been determined to be a "significant factor" contributing to the "Market Share Losses" for those years and in multiple arbitration hearings brought by the Majors against various Settling States, they are seeking to prove those States did not "diligently enforce" the statutory output penalties against the NPMs. *See, e.g.*, *State of New York v Philip Morris, Inc.*, 8 N.Y.3d 574, 869 N.E.2d 636 (2007).

In these NPM Adjustment proceedings, the Settling States themselves put in evidence showing that their Enforcement Statutes had succeeded in substantially eliminating NPM sales in the Settling States. This evidence was part of the record in the trial court and in the record on appeal. As

shown by the charts, *supra*, p. 14 and p. 17, their success in achieving this elimination of NPM competition dovetailed with the ever increasing enactment of ASR Repealers throughout the Settling States starting in 2003 and continuing through 2006 as well as with the reversal of the decline in OPM operating profits starting in 2004. Chart p. 6, *supra*.

The MSA Output Cartel Has Victimized And Continues To Victimize The Settling States

The irony of the MSA output cartel is that the Settling States themselves are the continuing captive victims of that cartel. As the prices of the Majors go up and their volume goes down, the Majors' share of the supracompetitive revenue keeps increasing while the Settling States' share of the annual settlements increasingly dwindles.

The platform for the Majors forcing the 46 Settling States into the MSA consisted of the settlements they made in the first half of 1998 with each of the four PSS. Unlike the restraints the Majors insisted upon being built into the MSA, none of these settlements required those PSS to enact any statutory output penalties on NPMs, any payments by NPMs into escrow funds, or any NPM Adjustments. The Majors' most persuasive point for getting the Settling States to agree to the terms of the MSA was providing that the annual payments in each of these PSS settlements were based upon the *national* sales that the Majors made, not upon the local sales within that state itself. The effect of hinging these settlements to national sales was that the smokers of the other

46 States were bearing most of the cost of these four settlements.

Judge William Pryor, now of the Eleventh Circuit, was the Attorney General of Alabama in 1998 when the MSA was negotiated. He opposed the States entering into the MSA on the ground that it was set up to put in place and enforce a nationwide grid of state statutes designed to establish and perpetuate higher cigarette prices nationwide. In an article subsequent to its formation, he explained why the Settling States had been forced into making this bad deal with its anticompetitive restraints of statutory output penalties on NPMs, *i.e.*, the NPM Adjustment, the Volume Adjustment on the annual payments to the Settling States, and the market share exemption to grandfathered SPMs:

> The settlement created a nationwide increase in the price of cigarettes to fund payments to all states; if a state refused to participate in the settlement, the smokers of that state nevertheless would pay higher prices to fund payments to other states [*i.e.*, the four PSS]. States that opposed the deal as 'too soft' on the industry likewise were in a difficult position. That is why all 46 states that had not already settled with the industry agreed to the settlement.

William Pryor, *A Comparison of Abuses and Reforms of Class Actions And Multigovernment Lawsuits*, 74 Tul. L. Rev. 1885, 1911 (2000).

Thus, in the Summer and Fall of 1998, in negotiating the terms of the MSA with the Majors, the Settling States were faced with the receipt by the

PSS of settlements based on national sales, most of which were in their states. They sought to stop the annual transfer of the hundreds of millions of dollars out of their territories and into the PSS as quickly as possible. This motivation apparently was so strong they agreed to the MSA restraints set forth above. One final concession. they agreed to pay roughly half of the annual settlement payments the Majors were making to the PSS: the so-called PSS Reduction from the annual settlement payments. MSA § II(j)(k); MSA § IX(c)(1). For the years 1997-2007, when the record herein was closed, through this "reduction" the Settling States have reimbursed the Majors $6.8 billion from their payments to the Settling States—about half of what the Majors paid to the PSS during those years.

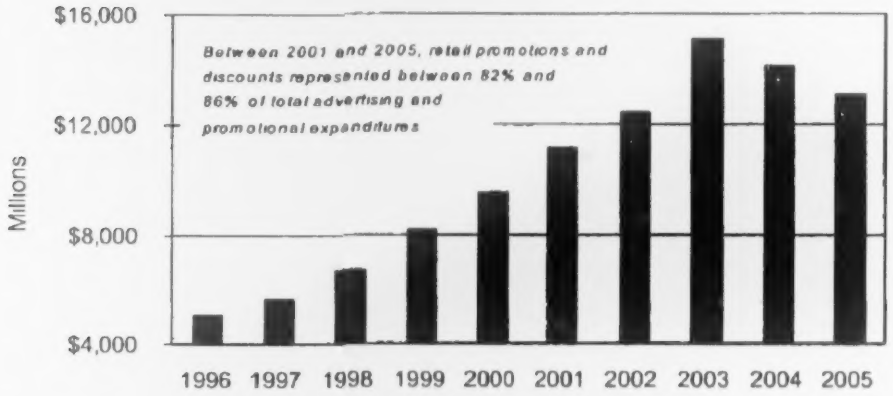
In short, the MSA has been a win-win agreement for the OPMs, the grandfathered SPMs and the trial lawyers representing Settling States that get a minimum payment of $500 million/year as long as the MSA is in effect. MSA § XVII. The losers are the consumers in the Settling States, the Settling States themselves and the NPMs in those States.

The OPMs and GFSPMs Have Dedicated A Substantial Portion of their Excess Profits Generated by the MSA Restraints To Successfully Recruiting Youths

As shown by the following chart, starting in 1999 and continuing through 2005, the OPMs and GFSPMs dedicated tens of billions of dollars out of their supra-competitive revenues into making dollar promotional expenditures. These annual

expenditures were several multiples more than what they spent on promotions and advertising during 1996-1998.

Domestic Cigarette Advertising and Promotional Expenditures
(1996-2005)



Source FTC Cigarette Report for 2004 and 2005 Tables 2B & 2C

In *United States v. Philip Morris USA, Inc.*, 449 F. Supp.2d 1 (D.D.C. 2006), *aff'd on liability*, 566 F.3d 1095 (D.C. Cir. 2009), Judge Kessler made detailed findings of fact and conclusions of law, finding the OPMs, particularly post-MSA, have conspired together to violate the substantive provisions of Rico, 18 U.S.C. § 1962(d), by expending billions of dollars post-MSA to recruit youths as replacements for older smokers who either quit or died. *Id.* at 676-691.

The Failed Efforts Of The Settling States To Escape Their Victimization

The Settling States argue that the MSA restraints resulting in high prices promote public

health because they deter smoking. A flat excise tax on the sales of *all* cigarette producers—OPMs, SPMs and NPMs—is the simple and obvious solution for deterring teenage smoking through higher prices. *FH I* pointed out (at 230) that "the State offers no reasons why it used methods suppressing competitors rather than a flat tax to achieve the same result." A flat excise tax on all cigarettes at least equal to the maximum per carton MSA Base Annual Settlement Payment would eliminate the Volume Adjustment, the market share exemption for grandfathered SPMs, the penalties to the State from the NPM Adjustment, and the PSS Reduction from the annual settlement payments to the Settling States. In addition, millions of dollars now going into the escrow fund payments would be eliminated with such payments being made directly to the States. Thus, if enacted by most of the Settling States, a flat tax would result in literally billions of dollars every year going to state treasuries rather than to the OPMs and grandfathered SPMs. In addition, such a flat tax would eliminate the continuing annual multibillion dollar a year promotional campaign of the OPMs to recruit youths as replacement for the older smokers that quit or die, because the OPMs would no longer have the supracompetitive revenues generated by the output cartel.[8]

The evidence herein showed that by mid-2006 at least 21 of the Settling States introduced and

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[8] Another irony of the MSA cartel is that the Settling States in obtaining annual settlement payments based on volume have a vested financial incentive in the Majors recruiting new smokers. A flat tax would eliminate this incentive.

sought to enact such flat tax bills.[9] Not surprisingly, none of these bills was actually enacted. The evidence showed that over the course of the years through 2006, the OPMs and the grandfathered SPMs have poured millions of dollars into successfully lobbying against the enactment of these flat taxes. Consequently, the continued victimization of the Settling States goes on unabated. The ultimate irony of this victimization consists of the performance of the various State Attorneys General, including the defendant herein, to "diligently enforce" their Escrow Statutes by opposing the various actions, including this one, seeking to enjoin their enforcement. And they have done a very credible professional job in discharging that covenant. Had they not, that would have been a factor in the OPM's pursuit of NPM Adjustments.

REASONS FOR GRANTING THE WRIT

The MSA output cartel will continue to thrive as long as the statutory NPM output penalties are not enjoined. There are two related reasons for granting the writ—one economic and social, and the other jurisprudential. The economic and societal interests are of national importance. Granting the writ will allow the Court to consider whether to stop the continued victimization of the millions of consumers within the Settling States by being

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[9] As of 2006, the OPMs and grandfathered SPMs had successfully defeated or tabled flat tax bills in the last few years in the following jurisdictions Alabama, California, Connecticut, Indiana, Kentucky, Massachusetts, Michigan, New Hampshire, New Jersey, New York, Nevada, North Carolina, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Utah, Vermont, Virginia, and West Virginia

overcharged billions of dollars yearly in those States. The Court's ruling will directly affect the continued spending of billions of dollars yearly in recruiting new youths as smokers as well as the ability of the Settling States to enact statutory flat rate taxes that would quickly remedy these economic and societal injustices and increase their excise tax revenues by billions of dollars. It would also affect whether the small manufacturers and importers that have now been eliminated by virtue of the MSA output restraints, including the named plaintiffs herein, can reestablish business in those States.

As to the jurisprudential reasons, the core issue common to both the dormant Commerce Clause and the Sherman Act claims is whether a group of cigarette manufacturers, the OPMs and the grandfathered SPMs, controlling about 95% of the national market should continue carrying out their output cartel so as to continue the injustices set forth above.

The dormant Commerce Clause claim deals with the issue of whether to stop the resurrection of the Balkanization formerly presented by the Articles of the Confederacy and then rectified by enactment of the Commerce Clause. *See H.P. Hood & Sons, Inc. v. DuMond*, 336 U.S. 525, 533-34 (1949); Michael S. Greve, *Federalism's Frontier*, 7 Tex. Rev. L. & Pol., 93, 101-04 (2002). The effect of the MSA has been to create a *de facto* economic nation within the 46 Settling States in which those States get paid for their protecting the dominant firms in the cigarette industry by imposing statutory penalties on other competitors so that

the OPMs can continue overcharging consumers therein.

Turning to the antitrust issue, it too presents an anticompetitive issue of national significance that this Court should decide. Prior to the issuance of the lower court decisions granting immunity to the participation by the various States in the MSA output cartel, it was accepted law that the participation by any entity for its own pecuniary gain in an output cartel was illegal *per se*. *See, e.g., Parker v. Brown*, 317 U.S. 341, 351-352 (1943). *FH VII*'s concludes that even though the State shares in the profits of such a cartel, it nevertheless is not an "active participant" therein because the State "neither manufactures nor distributes in the market." *Id.* at 61, A46. These decisions present a *de novo* judicially created antitrust exemption allowing States to participate in illegal interstate enterprises. If allowed to stand, any State or group of States are in effect granted antitrust immunity for participating in interstate cartels.

There are powerful vested political and governmental interests dedicated to perpetuating the fruits of the MSA output cartel. The violations of both the dormant Commerce Clause and the Sherman Act are clear-cut. The refusal to confront these facially obvious violations by the lower courts, discussed *infra*, can be negated only by this Court.

I. THE DORMANT CLAUSE VIOLATION

It would seem self-evident that an agreed upon concert of action among the Settling States to enact and enforce output penalty statutes on cigarette producers not participating in a settle-

ment agreement with the result of raising cigarette prices nationwide violates the dormant Commerce Clause. In any event, this Court in *Healy v. The Beer Institute*, 491 U.S. 324 (1999), articulated the rule condemning such conduct as violative of the dormant Commerce Clause as follows:

> . . . the practical effect of the [state] statute must be evaluated not only by considering the consequences of the statute itself, but also . . . what effect would arise if not one, but many or every, State adopted similar legislation.

Id. at p. 336.

Healy then went on to condemn the sort of interlocking grid of identical State statutes at issue here, explaining:

> The short-circuiting of normal pricing decisions based on local conditions would be carried to a national scale if a significant group of States enacted contemporaneous affirmation statutes that linked in-state prices to the lowest price in any State in the country. This kind of potential regional and even national regulation of the pricing mechanism for foods is reserved by the Commerce Clause to the Federal Government and may not be accomplished piecemeal through the extraterritorial reach of individual state statutes.

Id. at p. 340.

Grand River Enters. Six Nations, Ltd. v. Pryor, 425 F.3d 159 (2d Cir. 2005) ("*Grand River*"), reversed dismissal of the complaint in an action by a group of NPMs seeking to enjoin enforcement of these MSA statutory output penalties. It was brought against 31 attorneys general of various Settling States.[10] Circuit Judge John M. Walker authored the unanimous opinion in *Grand River* in which Circuit Judge Rene Raggi concurred. Those two judges were also on the Panel deciding *Freedom Holdings VII*, with the unanimous opinion written by Judge Raggi.

Grand River, following and quoting *Healy*, upheld a complaint alleging that the nationwide interlocking grid of identical escrow statutes enacted by all of the Settling States, and resulting in higher prices nationwide constituted a violation of the dormant Commerce Clause. *Grand River* explained that a small manufacturer either had to join the MSA as an SPM, paying into the settlement an amount "tied directly to the manufacturer's *national* market share" or "as an NPM must make escrow payments in each MSA state in which it sells cigarettes." *Id.* at 171-72 (emphasis in original). It held that the nationwide effect of the escrow fund payments would be proved if those escrow funds were "in part, keyed to the amount an NPM would have paid if it had joined the MSA as an SPM—a national-market-share-

[10] *Grand River* also held that *in personam* jurisdiction over these 31 Attorneys General in the Southern District of New York existed, finding that the attorneys general of the Settling States extentionally negotiated the terms of the MSA with the Majors in the Southern District of New York and finalized that agreement in that form. 425 F.3d at 166-68

dependent amount." *Id.* at 172. Because on their face the Escrow Statute did so provide, it concluded:

> Accordingly, appellants have successfully stated a possible claim that the practical effect of the challenged statutes and the MSA is to control prices outside of the enacting states by tying both the SPM settlement and NPM escrow payments to national market share, which in turn affects interstate pricing decisions.

Id. at 173.

FH VII acknowledged that the enforcement of these substantially identical statutes throughout the Settling States "has caused cigarette prices to rise nationwide . . . ." *FH VII* at 66; A58. Nevertheless, it held that there was a failure of proof of a consent of action because the plaintiffs "simply label [the] state statutes an interlocking grid and assume that judicial condemnation will follow under the Commerce Clause." *FH VII* at 65; A54. Defendants did not make this point either in the trial court or on appeal, and this curious finding of fact was *sua sponte*. It is simply not so.

In *Grand River*, after summarizing the pertinent provisions of the MSA, Judge Walker found that "[i]t is undisputed that the Escrow Statutes are an integral part of the nationwide settlement effected by the MSA" and that "the various Attorneys General purposefully dedicated five months to negotiating the MSA and the interconnected Model Escrow legislation with the Majors . . . ." *Id.* at 163 and 167. The MSA unambiguously provides that the Settling States, jointly and severally, entered into the MSA with the OPMs, MSA § I,

§ XVIII(l)&(o), and as a collective entity performed the covenants contained in the MSA requiring them to enact and enforce these statutory penalties on NPM output. In short, the undisputable facts show that these output penalty statutes form an interlocking grid.

Alternatively, *FH VII* ruled that *Grand River's* interlocking grid holding was inapposite because it was dealing with the threshold for refunds as contained in the original Allocable Release in the Escrow Statute, *i.e.*, escrow payments by an NPM to the given Settling State in excess of what that Settling State would have received from that NPM had it been a non-grandfathered SPM. *FH VII* at 64; A53. The Amendment, however, did not change the basic character of the refund: an excess of NPM escrow payments over what an NPM would have paid if it had been an SPM. It merely raised the threshold for refunds of per carton payments an NPM would have paid nationally to *all* of the Settling States if it had been an SPM, as opposed to what one State would have received. While this threshold is so high that it has never been reached, it is still keyed—just as was the original ASR—to national SPM per carton payments.[11]

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[11] As appears from Table I, *FH VI* at 691, B14, the table of escrow payments set up in the Model Statute, MSA Exh T, is computed so that the full escrow fund payment, after factoring in the Inflation Adjustment factor, MSA § II(x), is always a few cents lower than the full SPM annual national payment for any given year. The documented proof is that by making escrow payments nearly as large as those of non-grandfathered SPM annual payments, SPMs, like NPMs, simply cannot compete *See* Table 2, *FH VI* at 692, B15

The Opinion "[u]ltimately" relies on the ruling in *FH I* to the effect that '[m]ere upstream impact is not a violation of the dormant Commerce Clause, even if the impact is out-of-state where the stream originates.'" *FH VII* at 67; A60. Such reliance is paradoxical because both *FH I* at 221 and *Grand River* at 171 explicitly pointed out that this upstream pricing impact analysis was limited to the effect of this New York statute standing alone—the sole statute in the pleading before *FH I*. The Opinion thus effectively overrules *FH I* and *Grand River*, and directly conflicts with *Healy*. All illegal *per se* concerts of action, be they price fixes or output cartels, result in an "upstream pricing impact." That is their objective. What was pleaded and proved here was a concert of action by the Settling States to create the upstream pricing impact throughout the Nation. In short, *FH VII* directly conflicts with *Healy*. The vice, both in the dormant Commerce Clause context as well as in the antitrust context, is the creation by this horizontal concert of action resulting in an upstream pricing impact throughout the nation.

II. SECTION I OF THE SHERMAN ACT PREEMPTS THE IMPLEMENTATION OF THE COORDINATED ENFORCEMENT OF IDENTICAL STATE STATUTES IMPLEMENTING THE OUTPUT CARTEL

FH VII at 49, A21, discusses but does not question the illegality of the MSA output cartel itself. As the District Court found, their enforcement is required "to prevent the MSA from being destroyed." *FH VI* at 699, B30.

This action is the only one of all the reported cases challenging the MSA statutes where sales tax data of the Settling States was put in evidence. These data established the virtual elimination of the NPMs within the 46 Settling States. Both the trial court, *FH VI*, and the Second Circuit, *FH VII*, ignored this relevant market alleged in the complaint and proved at trial. The market, properly delineated, compels a conclusion of illegality. Instead of looking at this market, however, both *FH VI* and *FH VII* created their own nationwide market. They did this by adding onto the NPM market share in the Settling States the sizeable market share of the NPMs in the PSS where these enforcement statutes do not exist. *FH VII* at 47, A16, *FH VI* at 691, B13. This judicially erected "relevant" market enabled these courts to arrive at the facially incorrect conclusion as a matter of law that the enforcement of those output penalty statutes has created no substantial elimination of competition.

Once the proper relevant market is examined, *i.e.*, the 46 Settling States, and once the result of the collaborative action of the Settling States in enforcing these statutory penalties throughout that relevant market is recognized, namely, the virtual elimination of NPM competition within that market, the legal issue is whether the legality under Section 1 of the Sherman Act of the continued elimination of that competition within that relevant market for the States' own pecuniary and proprietary interests implements an illegal *per se* output cartel. *FH I* at 224.

The creators of the MSA constructed an output cartel never before seen. The restraints incorpo-

rated within the MSA, the Volume Adjustments, the Relevant Market Share Adjustment and the market share exemption for GFSPMs, are run-of-the-mine illegal output restraints penalizing producing members in a cartel for exceeding their agreed-upon quotas.[12] The unique restraint that sets the MSA apart from any other output cartel is the covenanted participation by the Settling States as paid participants in protecting the market share and profits of the OPMs and GFSPMs. That participation consists of substantially eliminating NPM competition in the Settling States.

FH VII effectively overruled *FH I* and *FH II* on the applicability of Section 1 of the Sherman Act to these state statutes. It relied on the unilateral-act-of-state doctrine as applied to the regulation in *Hoover v. Ronwin*, 466 U.S. 588 (1984). *FH VII* at 62, A50-51. *Hoover* involved a rule issued under the auspices of the Supreme Court of Arizona regulating admission of lawyers to the State bar. It held that the rule did not violate the Sherman Act because it was a) intrastate, not interstate in character, b) truly regulatory, and c) a unilateral act. By contrast, the enforcement of these State statutory penalties are collaborative efforts among the Settling States directly affecting interstate commerce and are not regulatory in nature but enforced to enhance the proprietary interests of those States.

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[12] These restraints are typical output penalties *See, e.g* , the lysine output cartel condemned in *United States v. Andreas*, 216 F 3d 645 (7th Cir 2000), and in the spot oil market cartel of *United States v Socony-Vacuum Oil Co.*, 310 U.S 150, 223 (1940), Bork, *The Antitrust Paradox*, p 262-67 (The Free Press 1993).

Another rationale used by most of the MSA decisions for finding no preemption by the Sherman Act of these output penalty statutes is their misapplication of the hybrid restraints concept developed in *Rice v. Norman Williams Co.*, 458 U.S. 654, 661 (1982).[13] Statutes explicitly favoring a group of competitors such as horizontal regulation of resale pricing are classified at hybrid restraints. *Rice* held that preemption occurs only if such a statute mandates or authorizes illegal *per se* conduct in all cases. The statutes at issue here, however, are not hybrid restraints. They do not authorize or mandate private parties to do anything. On the contrary, in the MSA, the private parties here, the Majors, authorized or mandated the States to enact and enforce these statutes, and they carried out that mandate.

III. NEAR NATIONWIDE ENFORCEMENT OF THE STATUTORY OUTPUT PENALTIES SHOULD NOT BE PROTECTED BY THE DOCTRINE OF STATE ACTION IMMUNITY

Parker v. Brown, 317 U.S. 341 (1943), created the doctrine of state action immunity for violation of the antitrust laws. It applied the doctrine to the marketing of raisins by a farmers' cooperative organized and regulated under California law, engaged in the growing of raisins solely within the State of California. In creating the doctrine, *Parker* emphasized that it would not shield any State from liability for "becoming a participant in

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[13] *See S&M Brands, Inc. v Caldwell*, 614 F.3d 172 (5th Cir 2010), pet. for cert. pending, Dkt No. 10-622, *Tritent Int'l Corp v Kentucky*, 467 F 3d 547 (6th Cir 2006)

a private agreement or combination by others for restraint of trade," *id.* at 351-352, and stressed that the cooperative created by the State had an essential "local character." *Id.* at 363.

The Second Circuit in *FH I* posed this threshold issue for immunity as follows:

> [i]t is questionable whether *Parker* immunity extends to a cartel arrangement supported by a state solely to allow the state to share the monopoly profits as state revenue. . . . States may not shield private parties from competition solely to benefit those parties. The conflict with the Sherman Act is arguably not lessened by the fact that the private parties pay the state a share of their monopoly revenues for that protection. A state is quite able to raise revenue by taxing private parties who compete for the favor of consumers.

Id. at 357 F.3d at 229. The Second Circuit, both in *FH I* at 231-32, and *FH II*, did not resolve this threshold issue since it found that immunity was unavailable because the States in enacting and enforcing these statutes did not provide for any active supervision over the pricing activities of the Majors, the private firms whose interests are protected by these statutes. In so holding, *FH I* and *FH II* followed *California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. 97, 105 (1980) ("*Midcal*").

In reviewing the holding that this interstate combination of statutory output penalties is immunized, this Court should resolve the threshold question of extending the protection of that doctrine to an illegal enterprise of near nation-

wide scope. It was never faced by any of the courts below that granted such immunity.

FTC Chairman Pitofsky in objecting to the GSA, quoted in *FH I* at 230, explained that "[W]e don't give industries exemptions from the antitrust laws if we think the competitive system will work." The Antitrust Modernization Commission, formed pursuant to a Congressional directive and consisting of distinguished antitrust practitioners, issued its Report and Recommendations to the President and Congress in 2007. In it, the Commission admonished in Recommendation No. 61 (p. 21) that "[C]ourts should construe all immunities and exemptions from the antitrust laws narrowly" and recommended (p. 23) that "the courts should apply the state action doctrine more precisely and with greater attention to both Supreme Court precedences and possible consumer harm from immunized conduct." That was not done in the courts below.

FH VII purports to find compliance with the active supervision requirement of *Midcal* because in its view there is "nothing to supervise," 624 F.3d at 62, A48, explaining the Escrow Statute fixes the amount of funds that an NPM puts into escrow. That does not confront the issue. These statutes protect the market share of the Majors, thereby allowing them to raise prices without supervision. The issue is whether allowing them to do so necessarily violates the active supervision requirement. The whole purpose of the Majors creating the MSA was to provide market share protection while they raised prices without governmental constraint just as they sought to do in the failed GSA. In effect, *FH VII* has overruled *FH I* and *FH II* on this issue, creating a direct

intra-circuit conflict that the Second Circuit *en banc* allowed to stand by denying the petition for rehearing *en banc* in this case. It directly conflicts with this Court's ruling in *Midcal* and that of the Third Circuit in *A.D. Bedell Wholesale Co. Philip Morris, Inc., supra*, p. 6, at n.5.

For a court to rule that such immunity exists for proven illegal interstate conduct, it can only do so by concluding, either explicitly or *sub silentio*, that a group of States can illegally enter into and perform an agreement to eliminate competition throughout most of Nation and are entitled to state action immunity. It is this threshold question that this Court should resolve, not only in the interest of effective enforcement of the Sherman Act on a nationwide basis but also for the protection of the public interest and welfare.

Northern Securities Co. v. United States, 193 U.S. 197 (1904), held that a state or its officials may not directly regulate interstate commerce in a manner that inevitably and directly conflicts with federal antitrust laws. In striking down a New Jersey statute that authorized interstate conduct as necessarily illegal *per se* under the Sherman Act, the Court stated:

> It cannot be said that any state may give a corporation, created under the laws, authority to restrain interstate or international commerce against the will of the nation as lawfully expressed by Congress. Every corporation created by a state is necessarily subject to the supreme law of the land.

Id. at 346. *See also Parker* at 351-352.

The issue is whether the state action immunity doctrine should be expanded to sanctify the enforcement of these statutory penalties on output. Doing so conflicts with *Midcal* and, if not reviewed by this Court, gives States unchecked power to restrain interstate commerce.

CONCLUSION

The petition for certiorari should be granted.

Dated: New York, New York
January 20, 2011

Respectfully submitted,

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APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

August Term, 2009

(Argued: December 2, 2009
Decided: October 18, 2010)

Docket No. 09-0547-cv

FREEDOM HOLDINGS, INC., INTERNATIONAL TOBACCO PARTNERS, LTD., 1010 Northern Boulevard, Suite 208, Great Neck, NY 11021, on behalf of themselves and all others similarly situated,

Plaintiffs-Appellants,

—v.—

ANDREW M. CUOMO, in his offical capacity as Attorney General of the State of New York, ROBERT L. MEGNA, in his official capacity as Commissioner of Taxation and Finance of the State of New York,

Defendants-Appellees.

Before:

WALKER, RAGGI, *Circuit Judges*,
and RAKOFF, *District Judge*.*

Appeal from a judgment of the United States District Court for the Southern District of New York (Alvin K. Hellerstein, *Judge*), entered after a bench trial, which rejected plaintiffs' Sherman Act and Commerce Clause challenges to New York's Escrow and Contraband Statutes, enacted in furtherance of a 1998 Master Settlement Agreement ("MSA") between cigarette manufacturers and all but four states.

AFFIRMED.

DAVID F. DOBBINS (Nicolas Commandeur, Mark G. Young, *on the brief*), Patterson Belknap Webb & Tyler LLP, New York, New York, *for Plaintiffs-Appellants*.

SASHA SAMBERG-CHAMPION, Assistant Solicitor General (Barbara D. Underwood, Solicitor General; Benjamin N. Gutman, Deputy Solicitor General; Monica Wagner, Steven C. Wu, Assistant Solicitors General, *on the brief*), *for* Andrew M. Cuomo, Attorney General of the State of New York, *for Defendants-Appellees*.

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* District Judge Jed S Rakoff of the United States District Court for the Southern District of New York, sitting by designation

REENA RAGGI, *Circuit Judge*:

Plaintiffs Freedom Holdings, Inc., and International Tobacco Partners, Ltd., are cigarette importers. They filed this putative class action in the United States District Court for the Southern District of New York (Alvin K. Hellerstein, *Judge*) to enjoin the enforcement of New York statutes enacted in furtherance of a 1998 Master Settlement Agreement ("MSA") between a number of tobacco companies and various government entities, including New York State. Plaintiffs contend that the laws at issue, N.Y. Pub. Health Law §§ 1399-nn–1399-pp (the "Escrow Statute"), and N.Y. Tax Law §§ 480-b, 481, and 1846 (collectively, the "Contraband Statute"), impermissibly (1) restrain trade in violation of section 1 of the Sherman Act, 15 U.S.C. § 1; and (2) regulate out-of-state commerce in violation of the Commerce Clause, U.S. Const. art. I, § 8, cl. 3. Plaintiffs now appeal from a judgment entered in favor of defendants on January 14, 2009, after a bench trial. For the reasons stated in this opinion, we affirm.

I. *Background*

Numerous prior opinions of this court and the district court detail the extensive background of this case. *See Freedom Holdings, Inc. v. Spitzer* ("*Freedom Holdings I*"), 357 F.3d 205 (2d Cir. 2004); *Freedom Holdings, Inc. v. Spitzer* ("*Freedom Holdings II*"), 363 F.3d 149 (2d Cir. 2004); *Freedom Holdings, Inc. v. Spitzer* ("*Freedom Holdings III*"), 447 F. Supp. 2d 230 (S.D.N.Y. 2004); *Freedom Holdings, Inc. v. Spitzer* ("*Freedom Holdings IV*"), No. 02 Civ. 2939, 2004 WL 2251668

(S.D.N.Y. Oct. 6, 2004); *Freedom Holdings, Inc. v. Spitzer* ("*Freedom Holdings V*"), 408 F.3d 112, 115 (2d Cir. 2005); *Freedom Holdings, Inc. v. Cuomo* ("*Freedom Holdings VI*"), 592 F. Supp. 2d 684 (S.D.N.Y. 2009). We assume familiarity with these opinions and recite only the facts relevant to the decision reached today.

A. *The Master Settlement Agreement*

In November 1998, the nation's four dominant cigarette manufacturers—Philip Morris, Lorillard Tobacco, Brown & Williamson, and R.J. Reynolds[1] —settled pending litigation with forty-six states,[2] the District of Columbia, and five United States territories (collectively, "the states") by entering into the MSA. In return for releases from liability, these manufacturers agreed to make substantial annual payments to compensate the states for health care expenses incurred in the past and expected to be incurred in the future as a result of their populations' smoking-related ailments. New York's approval of the MSA is reflected in *State v. Philip Morris, Inc.*, 179 Misc. 2d 435, 686 N.Y.S.2d 564 (Sup. Ct. N.Y. Co. 1998), *aff'd*, 263 A.D.2d 400, 693 N.Y.S.2d 36 (1st Dep't 1999).

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[1] Brown & Williamson and R.J. Reynolds have since merged, forming Reynolds American, Inc.

[2] Four states—Florida, Minnesota, Mississippi, and Texas—settled litigation with the tobacco companies before the MSA was executed in 1998.

1. *The MSA's Treatment of Cigarette Manufacturers*

The MSA divides cigarette manufacturers into several groups. The first group consists of the four dominant manufacturers who initially executed the MSA. They are referred to as "original participating manufacturers," or "OPMs." The second group consists of more than fifty smaller manufacturers who joined the MSA after its initial execution. They are referred to as "subsequent participating manufacturers," or "SPMs." The SPMs are divided into two sub-groups: "grandfathered SPMs," who joined the MSA within sixty days of the initial November 1998 execution date;[3] and "non-grandfathered SPMs," who joined the MSA thereafter. A third group consists of manufacturers who have not joined the MSA. They are referred to as "non-participating manufacturers," or "NPMs." An NPM may become a non-grandfathered SPM at any time by signing the MSA and making prescribed payments.

2. *Payment Obligations*

The MSA specifies a total base payment to be made by all OPMs to the states each year. In 2009, the required base payment was $9 billion. The MSA allocates the annual base payment obligation among OPMs according to their relative market share of the total number of individual cigarettes shipped by the OPMs to the fifty states, the District of Columbia, and Puerto Rico during the preceding calendar year. The MSA then

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[3] By agreement of the parties, this sixty-day period was later expanded to ninety days

awards the base payment to the states based on prescribed allocable shares, which for New York is 12.76%.

SPMs make annual payments approximating payments made by OPMs. The advantage conferred on grandfathered SPMs for quickly joining in the MSA is that they are exempted from payments on either their 1998 market share, or 125% of their 1997 market share, whichever is greater. Thus, grandfathered SPMs pay an amount approximating the OPM payment only for each cigarette manufactured above the grandfathered threshold.

While the average per-cigarette cost of complying with the MSA is roughly equivalent among OPMs and SPMs above grandfathered thresholds, this court and the district court have observed that the SPM payment formula may, as an arithmetical matter, disproportionately increase marginal payment obligations when SPMs gain market share from OPMs. *See Freedom Holdings II*, 363 F.3d at 153; *see also Freedom Holdings VI*, 592 F. Supp. 2d at 698 n.15; *Freedom Holdings III*, 447 F. Supp. 2d at 258. In this case, we need not consider whether this formula raises antitrust concerns because plaintiffs are NPMs, not SPMs. *See infra* at [51-52 & n.14].

3. *Adjustments to Payment Obligations*

The MSA also provides for various adjustments to participating manufacturers' payment obligations. First, an "inflation adjustment" increases payment obligations by a minimum of 3% annually. Second, a "volume adjustment" reduces the required base payment if there is an overall decline in the volume of cigarettes sold nation-

wide. Third, if participating manufacturers lose market share relative to NPMs, an "NPM adjustment" reduces the required base payment by triple the amount of market share lost. *See* MSA § IX(d)(1)(A).[4]

B. *The Challenged Statutes*

1. *The Escrow Statute*

Under the MSA, a decline in the volume of sales by participating members necessarily decreases the payments received by the states. To the extent the decline is attributable to increased sales by NPMs, states can both make up for the lost MSA payments and avoid the NPM adjustment by enacting and diligently enforcing escrow statutes. *See* MSA § IX(d)(2)(B). The MSA contemplates that an escrow statute will "effectively and fully neutralize[ ] the cost disadvantages that the Participating Manufacturers experience vis-à-vis Non-Participating Manufacturers within such Settling State as a result of the provisions of [the MSA]." *Id.* § IX(d)(2)(E).

The settling states have, in fact, all enacted escrow statutes. The operative section of the New York Escrow Statute challenged in this case is codified at New York Public Health Law § 1399-pp. It requires each cigarette manufacturer either (1) to join the MSA as a participating manufacturer, *see id.* § 1399-pp(1); or (2) to make annual

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[4] If participating manufacturers lose more than 16-2/3% in market share, the decrease in payment obligations is calculated "by a complex formula potentially increasing the [participating manufacturers'] discount." *Freedom Holdings III*, 447 F Supp. 2d at 236

payments into a state escrow fund, *see id.* § 1399-pp(2). The statute specifies the amount of these annual escrow payments, which are adjusted for inflation. *See id.* at § 1399-pp(2)(a). Escrow funds are released if needed to pay certain judgments, to the extent an NPM paid more into the escrow fund than it would have paid as an SPM, or otherwise after twenty-five years. *See id.* § 1399-pp(2)(b).

As originally drafted, state escrow statutes, including New York's, also contained allocable share release provisions, which allowed an NPM to recoup escrow payments to the extent the NPM paid more into the escrow fund than a state's allocable share of MSA payments. This provided an incentive for NPMs to concentrate their sales in a single state or small group of states to minimize their escrow costs. Thus, an NPM that sold 100% of its cigarettes in New York could recoup 87.24% of its escrow payments because New York's allocable share of MSA payments is 12.76%. Meanwhile an NPM that sold the same number of cigarettes nationwide could recoup none of its escrow payments. To avoid this outcome, in 2003, New York, like other settling states, amended its Escrow Statute to permit NPMs to obtain a release of escrow payments only to the extent they exceeded the per-cigarette payments the NPMs would have made as participants in the MSA. *See* N.Y. Pub. Health Law § 1399-pp(2)(b)(ii).[5]

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[5] This amendment to the Escrow Statute states

> [T]o the extent that a tobacco product manufacturer establishes that the amount it was required to place into escrow *on account of units sold in the state* in a particular year was greater than the master settlement agreement payments, as determined pursuant to section IX(i)

2. *The Contraband Statute*

Between 1998 and 2002, MSA participants saw their market share of cigarette sales decline while NPMs' share rose. Attributing this situation, at least in part, to the failure of certain NPMs to comply with escrow statutes, a number of states enacted "contraband statutes."[6] *See Freedom Holdings I*, 357 F.3d at 213 (quoting Governor George Pataki's statement that New York's Contraband Statute would "bolster the State's ability to diligently enforce" the Escrow Statute and, thus, "help protect the State from further [NPM] adjustments" (internal quotation marks omitted) (alteration in original)). New York's Contraband Statute, codified at New York Tax Law §§ 480-b, 481(1)(c), and 1846, requires a tobacco manufacturer to certify annually either (1) that it is a participating manufacturer, or (2) that it has complied with the Escrow Statute. *See id.* § 480-b(1). New York agents cannot affix tax stamps to cigarettes if the manufacturer has not made the required certification. *See id.* § 480-b(2).

> of the master settlement agreement including after final determination of all adjustments, that such manufacturer *would have been required to make on account of such units sold* had it been a participating manufacturer, the excess shall be released from escrow and revert back to such tobacco product manufacturer "
>
> N Y. Pub Health Law § 1399-pp(2)(b)(ii) (emphasis added)

[6] Defendants suggest that these laws are "generally known as the directory statutes but referred to by plaintiffs as Contraband Statutes." Appellees' Br at 9 For the sake of consistency with prior opinions in this case, we use the term "Contraband Statute" to refer to the challenged provisions of the New York Tax Law

Cigarettes that do not bear a tax stamp are subject to seizure or forfeiture, *see id.* § 1846, and a civil penalty of up to $5,000 may be assessed on the non-compliant manufacturer, *see id.* § 481(1)(c).

C. *Prior Proceedings*

1. *Freedom Holdings I*

On April 16, 2002, plaintiffs commenced this action in the Southern District of New York, alleging that New York's Contraband Statute violated the Sherman Act, the Commerce Clause, and the Fourteenth Amendment. The district court dismissed the complaint for failure to state a claim, and plaintiffs appealed to this court.

We affirmed dismissal of the Commerce Clause claim, concluding that the Contraband Statute did not discriminate against out-of-state economic interests, burden interstate commerce, or regulate commerce occurring outside New York, as plaintiffs alleged. *See Freedom Holdings I*, 357 F.3d at 217-21.[7] Noting deficiencies in plaintiffs' Fourteenth Amendment equal protection claim, we remanded to the district court, so that plaintiffs could have an opportunity to amend their complaint. *See id.* at 235.[8]

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[7] In so doing, we reserved a question not raised by plaintiffs' complaint whether "any sort of interstate regulatory gridlock would occur if many or every state adopted similar legislation." *Freedom Holdings I*, 357 F.3d at 221 (internal quotation marks omitted).

[8] In *Grand River Enterprises Six Nations, Ltd v Pryor*, 425 F.3d 158 (2d Cir 2005), we held that the equal protection argument raised by a similar group of NPM plain-

At the same time, we reversed the dismissal of plaintiffs' antitrust claim, applying a two-step analysis that asked, (1) whether the Contraband Statute effected a *per se* violation of the Sherman Act and, if so, (2) whether it was nevertheless saved by the doctrine of state action immunity. Accepting plaintiffs' allegations as true, as we were required to do in reviewing a judgment of dismissal, we observed that the Contraband Statute "allegedly enforce[s] an express market-sharing agreement among private tobacco manufacturers, the MSA." *Id.* at 224. We determined that plaintiffs pleaded both market division and price fixing to the extent "market-share increases among manufacturers are substantially 'penalized'" by the MSA. *Id.* at 225. Thus, we concluded that plaintiffs adequately stated an antitrust claim by alleging that "the combination of the MSA, the Escrow Statutes, and the Contraband Statutes, allows OPMs to set supracompetitive prices that effectively cause other manufacturers either to charge similar prices or to cease selling." *Id.* at 226.

We next considered whether the doctrine of state action immunity shielded the Contraband Statute from application of the antitrust laws. *See California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. 97, 105 (1980). Although we were satisfied that the MSA regime was "clearly articulated and affirmatively expressed as

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tiffs was "unavailing because the Escrow Statutes are rationally related to a legitimate state interest promoting public health and recovering the costs of tobacco-related illnesses," *id.* at 175. Plaintiffs have not pursued their equal protection claim either on remand or in this court.

state policy," the first prerequisite for state action immunity, *Freedom Holdings I*, 357 F.3d at 226-27, we concluded that the complexity of the MSA scheme precluded determination at the dismissal stage as to whether the state was motivated by legitimate policy goals or by an impermissible desire to share in monopoly profits, *see id.* at 227-31. We concluded further that the state was not entitled to immunity at the pleading stage because it had yet to make the required evidentiary showing that it actively supervised pricing decisions made by cigarette manufacturers participating in the MSA. *See id.* at 231-32.

2. *Freedom Holdings II*

In response to defendants' petition for rehearing, we issued a second opinion expanding on our reasons for reversing dismissal. *See Freedom Holdings II*, 363 F.3d 149. First, we observed that "[a]ccording to the complaint, the function of the Escrow Statute is to coerce NPMs to join the MSA because the costs of compliance with the Escrow Statute are substantially higher than the costs of being an SPM." *Id.* at 152; *see also id.* at 154.

Second, we identified the core aspect of the alleged market division as the SPM pricing formula. Parsing that formula, we noted that it was possible that SPMs were penalized for gaining market share from OPMs because, "under the MSA, if the numerator increases because the SPM has taken market share from an OPM, the denominator decreases by the amount of the increase. Thus, the SPM's proportion of the annual payment increases by more than its proportion of overall market share." *Id.* at 153. We, therefore, rejected

defendants' contention that, as a matter of law, an SPM's marginal payment per cigarette is always lower than an OPM's per-cigarette payment, and we concluded that plaintiffs should be afforded an opportunity to prove that "payments increase disproportionately (i.e. in more than a 1 to 1 ratio) when market share increases." *Id.*

Third, as to state action immunity, we reiterated that, as alleged in the complaint, the Contraband Statute was subject to the two-part analysis of *California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. at 105, because NPMs are "forced . . . to become part of the market-sharing agreement set up by the MSA," *Freedom Holdings II*, 363 F.3d at 154. Thus, "the Challenged Statutes have the effect, according to the allegations of the complaint, of delegating price-setting authority to the OPMs." *Id.* at 155. In any event, it was "too soon to say whether the state will ultimately be able to elicit evidence sufficient to meet" the second, active supervision, prong of *Midcal* analysis. *Id.* at 157.

3. *Freedom Holdings III, IV, and V*

On remand after our decisions in *Freedom Holdings I* and *Freedom Holdings II*, plaintiffs amended their complaint and moved for a preliminary injunction barring enforcement of New York's Escrow and Contraband Statutes. On September 14, 2004, the district court preliminarily enjoined enforcement of the Escrow Statute's allocable share release amendment, but it denied the motion in all other respects, *see Freedom Holdings III*, 447 F. Supp. 2d at 233, thereafter also denying rehearing, *see Freedom*

Holdings IV, 2004 WL 2251668. Plaintiffs appealed, and we affirmed the denial of broader injunctive relief because plaintiffs failed to demonstrate the requisite likely irreparable harm. *See Freedom Holdings V*, 408 F.3d at 115. We did not discuss the likelihood of plaintiffs' success on the merits.

4. *Grand River*

In *Grand River Enterprises Six Nations, Ltd. v. Pryor*, 425 F.3d 158 (2d Cir. 2005), we considered a second Commerce Clause challenge to the MSA. The *Grand River* plaintiffs alleged that New York's Escrow and Contraband Statutes effectively "force out-of-state merchants to seek New York regulatory approval before undertaking an out-of-state transaction, [and] that . . . interstate regulatory gridlock would occur if many or every state adopted similar legislation." *Id.* at 171 (quoting *Freedom Holdings I*, 357 F.3d at 221 (internal quotation marks omitted)). Taking "no position as to the ultimate viability" of this contention, we concluded that the pleading should not have been dismissed as a matter of law because the *Grand River* plaintiffs "stated a possible claim that the practical effect of the challenged statutes and the MSA is to control prices outside of the enacting states by tying both the SPM settlement and NPM escrow payments to national market share, which in turn affects interstate pricing decisions." *Id.* at 173.

D. *Freedom Holdings VI: The Challenged Judgment*

On February 10, 2006, plaintiffs again amended their complaint to add a Commerce Clause claim conforming to *Grand River*. After discovery closed, the district court commenced a three-day hearing on November 18, 2008, after which it entered judgment for defendants as if after a bench trial pursuant to Federal Rule of Civil Procedure 52. *See Freedom Holdings VI*, 592 F. Supp. 2d 684.

1. *Findings of Fact*

Relying on data compiled by Pricewaterhouse Coopers in the course of its duties as the independent auditor responsible for calculating payment obligations and reporting data to the states and participating manufacturers under the MSA, the district court made a number of findings, including the following:

First, "the payment structure of the MSA does not favor the major cigarette companies over" SPMs and NPMs. *Id.* at 691. "[U]pdated reports reveal[ed]" that "OPMs continue to pay more per carton ($5.31 in 2007), including payments to the four previously settled states, than do the non-grandfathered SPMs ($5.07), and both pay more than NPMs pay under the Escrow Statutes ($5.02)." *Id.* While "[g]randfathered SPMs, viewed in isolation, have the lowest average payment obligation ($2.63), since they pay nothing for cigarettes sold up to their grandfathered threshold," *id.*, credible expert testimony indicated that marginal cost, not average cost, determined price, *see id.* at 698. The marginal cost for cigarette

sales above the grandfathered threshold was "about what non-grandfathered SPMs pay ($5.07), which is more than NPMs pay." *Id.* at 691.

Second, NPMs had not "suffered," but rather "prospered," under the combined effect of the MSA and challenged state statutes. *Id.* at 697. Specifically, while OPMs' total market share declined from 97.1% to 85.9% between 1997 and 2007, NPM market share during that same period increased "from 0.4% in 1997 to a peak of 8.1% in 2003, . . . to 5.4% in 2007." *Id.* at 691.[9] The "figures" cited in these two groups of findings "undermine" defendants' argument "that 'NPMs are deterred from seeking increased market share because the high costs of compliance with the Escrow Statute preclude their competing through lower prices.'" *Id.* at 697. Indeed, this conclusion obtained even if plaintiffs had proved—which they did not—that the MSA discouraged competition among OPMs. The evidence showed not only that NPMs could exploit disproportionate price increases by MSA participants, but that they "have done so vigor-

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[9] The district court found the decline in market share between 2003 and 2007 explained by the fact that "General Tobacco, the largest NPM to become a non-grandfathered SPM, joined the MSA in July 2004, which accounts for the fact that the SPMs' total market share has expanded slightly at the NPMs' expense in the years since." *Freedom Holdings VI*, 592 F. Supp. 2d at 691 n.5. Further, the court observed that the data supplied by Pricewaterhouse Coopers likely "understate[d] NPM sales because many NPMs sell cigarettes through the Internet or Indian reservations to avoid federal excise tax collection," which sales the accounting firm does not consider in identifying market shares *Id* at 692.

ously to the NPMs' market advantage." *See id.* at 699.[10]

Third, "[n]o evident economic force drives NPMs to the MSA." *Id.* at 697. Insofar as plaintiffs complained that NPMs faced a relative tax hardship because escrow payments, in contrast to MSA payments, are not tax deductible, plaintiffs ignored

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[10] The district court also cited the "important public health goals and substantial fiscal benefits" of the MSA regime, *Freedom Holdings VI*, 492 F Supp 2d at 700, in concluding that it did not represent a "naked" restraint of trade lacking "'any redeeming virtue,'" *id* at 696 (quoting *Rice v. Norman Williams Co.*, 458 U S 654, 659 n.5 (1982)), *see also Freedom Holdings III*, 447 F. Supp 2d at 248-54 (concluding *per se* rule should weigh social benefits of MSA).

For the reasons stated *infra* at [51-56], we conclude that plaintiffs failed to prove their antitrust claim under a traditional application of the *per se* rule. Thus, we need not here decide whether a state's beneficent purpose can ever save an otherwise illegal restraint of trade from Sherman Act preemption *See National Soc'y of Prof'l Eng'rs v United States*, 435 U S 679, 692 (1978) (observing that "purpose of [antitrust] analysis is to form a judgment about the competitive significance of the restraint, it is not to decide whether a policy favoring competition is in the public interest, or in the interest of the members of an industry"), *compare* I Phillip E Areeda & Herbert Hovenkamp, *Antitrust Law* ¶ 217b4, at 366-67 (3d ed 2006) (criticizing *Freedom Holdings III* for effectively applying rule of reason and remarking that "[w]hether more or less cigarette smoking is healthy or unhealthy is an important policy concern, but it is not one that is properly effected through the device of an unsupervised cartel agreement"), *with* Daniel A. Crane, *Harmful Output in the Antitrust Domain. Lessons from the Tobacco Industry*, 39 Ga. L Rev. 321, 326 (2005) (noting that antitrust enforcement in tobacco industry has traditionally focused on increasing output but suggesting different considerations for "net-harm industries").

an important distinction: MSA participants could "not recover their payments once made, while NPMs receive annual interest earnings on escrowed funds and will recover, after twenty-five years, any funds not applied to judgments or settlements with the States." *Id.* If plaintiffs eliminated these differences "by disclaiming their rights to interest income and reversion of principal," they would be "eligible to deduct their [escrow] payments." *Id.*

Fourth, plaintiffs failed to prove that the MSA "caused [them] or other NPMs to surrender pricing autonomy." *Id.* at 698. To the contrary, Christopher Nelson, chief financial officer of NPM Freedom Holdings, and Jeffrey Avo Uvezian, president of NPM International Tobacco Partners, testified that "their pricing decisions are made independently and that they are not compelled to follow price leadership by their larger competitors." *Id.* Similarly, Kevin Altman, who set prices for two NPMs, CigTec and JJA Distributors LLC, "testified that both companies made independent pricing decisions that were not dictated by OPMs or SPMs." *Id.* "The aggregate historical data" not only supported this testimony, it demonstrated that "NPMs have taken competitive advantage of higher prices charged by the large cigarette manufacturers." *Id.* "Only the Escrow Statutes," not the MSA, have an impact on "NPMs' cost structure." *Id.* Their effect, however, was akin to a "flat tax," which did not violate antitrust laws. *Id.* at 699.

2. *The Antitrust Claim*

In light of these findings, the district court entered judgment for defendants on plaintiffs' antitrust claim, holding that plaintiffs had failed to carry their burden to prove a *per se* violation of the Sherman Act:

> [T]he MSA does not mandate or authorize conduct that necessarily constitutes a violation of the antitrust laws in all cases, or place irresistible pressure on a party to violate the antitrust laws in order to comply with the [agreement]. The continued strength of NPMs proves as much, and the absence of financial pressure on NPMs to join the MSA confirms it. Nothing in the Escrow or Contraband Statutes mandates or authorizes illegal conduct in all cases, an essential ingredient of a per se antitrust violation.

Id. at 700 (internal quotation marks and modifications omitted).[11]

Alternatively, the district court concluded that the challenged statutes were shielded from Sherman Act preemption by state action immunity according to the two-part test articulated in *California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. 97. First, addressing the question of purpose that *Freedom Holdings II* determined could not be decided on the pleadings, the district court identified a "plausible nexus" between various provisions of the MSA and the

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[11] Accordingly, the district court also dissolved its preliminary injunction against enforcement of the allocable share release amendment to New York's Escrow Statute

states' twin goals of decreasing cigarette consumption and raising revenues to meet health costs associated with such consumption. *Freedom Holdings VI*, 592 F. Supp. 2d at 701. Second, the district court determined that New York actively supervised the competitive effects of the MSA by closely tracking data provided by the MSA auditor. *See id.* at 702. The district court identified no need for greater supervision in light of its findings that NPMs were able to gain market share under the challenged scheme. *See id.*

3. *Commerce Clause Claim*

The district court also entered judgment for defendants on plaintiffs' claim that the extraterritorial effects of "interlocking" state escrow statutes violate the Commerce Clause by creating a uniform, national system of cigarette regulation. While the enactment of similar escrow statutes by a number of states contributed to the national increase in cigarette prices, the district court concluded that this did not equate to regulation of interstate commerce by New York because plaintiffs failed to show that "commercial actors outside New York are bound in some way by the dictates of New York statutes." *Id.* at 707.

Plaintiffs timely appealed the district court's judgment.

II. *Discussion*

A. *Standard of Review*

On appeal from a bench trial, we accord considerable deference to a district court's findings of fact, which we will reverse only for clear error. We

review its conclusions of law, or mixed fact and law, *de novo*. *See Skoros v. City of New York*, 437 F.3d 1, 12 (2d Cir. 2006). We may affirm the district court's decision on any ground appearing in the record. *See Liberty Mut. Ins. Co. v. Hurlbut*, 585 F.3d 639, 648 (2d Cir. 2009).

B. *Antitrust Claim*

In challenging the trial judgment, plaintiffs submit, as they have throughout this litigation, that the Sherman Act preempts New York's Escrow and Contraband Statutes because those laws "implement[ ] the illegal *per se* output cartel set up in the MSA." Second Supp. & Am. Compl. Prayer for Relief ¶ 2. As we recognized in *Freedom Holdings I*, 357 F.3d at 222-23, a two-step inquiry guides analysis of this claim.

First, the party asserting preemption must demonstrate an "irreconcilable conflict" between the challenged statute and the Sherman Act. *Rice v. Norman Williams Co.*, 458 U.S. 654, 659 (1982). Such a conflict will be found only "when the conduct contemplated by the statute is in all cases a *per se* violation" of the antitrust laws. *Id.* at 661; *accord Freedom Holdings I*, 357 F.3d at 223. Only "manifestly anticompetitive" restraints "lack[ing] any redeeming virtue"—*e.g.*, if competitors privately agree among themselves to fix prices or to divide markets—constitute such *per se* violations. *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877, 886-87 (2007) (internal quotation marks and ellipsis omitted).

By contrast, restraints "unilaterally imposed by government . . . to the exclusion of private control" do not violate the antitrust laws. *Fisher v. City of*

Berkeley, 475 U.S. 260, 266 (1986); *accord Massachusetts Food Ass'n v. Mass. Alcoholic Beverages Control Comm'n*, 197 F.3d 560, 563 (1st Cir. 1999) (Boudin, J.). Where, however, state law does not regulate unilaterally but, rather, grants private actors a degree of regulatory control over competition, the statute may be preempted as a "hybrid" restraint on trade. *See 324 Liquor Corp. v. Duffy*, 479 U.S. 335, 345-46 & n.8 (1987); *accord Freedom Holdings I*, 357 F.3d at 223; *see also* I Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law* ("Areeda & Hovenkamp"), ¶217a, at 352 (3d ed. 2006). The touchstone at the first step of inquiry is, therefore, whether the challenged New York statutes "'mandate[] or authorize[]'" private antitrust violations. *Fisher v. City of Berkeley*, 475 U.S. at 265 (quoting *Rice v. Norman Williams Co.*, 458 U.S. at 661).

Second, even if plaintiffs showed that the challenged statutes mandate or authorize a *per se* antitrust violation, those laws might still be saved from preemption by the doctrine of state action immunity, *see Parker v. Brown*, 317 U.S. 341 (1943), if the anti-competitive conduct at issue is both "clearly articulated and affirmatively expressed as state policy" and "actively supervised by the State itself," *California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. at 105 (internal quotation marks omitted). In making this determination, our concern is not with whether the challenged statutes benefit consumers. *See Rice v. Norman Williams Co.*, 458 U.S. at 659 ("A state statute is not preempted by the federal antitrust laws simply because the state scheme might have an anticompetitive

effect."). The critical question is whether the statutes reflect actual state policy outside the purview of the Sherman Act, *see Parker v. Brown*, 317 U.S. at 351, or whether the state has merely "cast[ ] . . . a gauzy cloak of state involvement over what is essentially a private price-fixing arrangement," in which case preemption will follow, *California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. at 106.[12]

On appeal, plaintiffs rely heavily on our decisions in *Freedom Holdings I* and *Freedom Holdings II* in arguing that the district court erred at both steps of the preemption analysis. When we reviewed the dismissal of plaintiffs' complaint in *Freedom Holdings I* and *Freedom Holdings II*, however, plaintiffs were required only to demon-

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[12] Some courts and commentators have observed that the two steps of inquiry may ovlap. *See, e g., Costco Wholesale Corp v Maleng*, 522 F.3d 874, 887-88 (9th Cir 2008) To determine whether a statute mandates or authorizes a *per se* violation, a court must consider whether the challenged restraint "ha[s] been unilaterally imposed by government " *Fisher v. City of Berkeley*, 475 U.S at 266 A finding of unilateral imposition "effectively merge[s]" into the state action immunity inquiry insofar as it concludes that the challenged statute does not delegate any unsupervised discretion to private parties. *Costco Wholesale Corp v Maleng*, 522 F 3d at 887, *see also* 1 Areeda & Hovenkamp, *supra*, ¶ 217d, at 372 (noting that *Fisher* "use[d] *Parker* to show that the [challenged] ordinance passed the *Rice* test"), Merrick B Garland, *Antitrust and State Action· Economic Efficiency and the Political Process*, 96 Yale L.J. 486, 507 (1987) (suggesting that *Fisher*'s "preemption analysis collapses into the *Midcal* test") Likewise, "the 'state action' exemption from the antitrust laws simply expresses the conclusion that certain state laws are not preempted." I Areeda & Hovenkamp, *supra*, ¶ 217d, at 370.

strate that they could prove some set of facts in support of their claim. *See Freedom Holdings I*, 357 F.3d at 215 ("A complaint cannot be dismissed for failure to state a claim 'unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief.'" (quoting *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957)).[13] After a trial judgment in favor of defendants, plaintiffs must be able to point to record evidence that precluded the district court from finding, as it did, that the challenged statutes are unilateral state actions that do not mandate or authorize private parties to restrain trade or, in any event, that the statutes are not subject to Sherman Act preemption by virtue of the state action immunity doctrine. We conclude that the district court was not precluded from making either determination.

1. *Plaintiffs' Claim of a* Per Se *Violation of the Sherman Act*

a. *Plaintiffs Must Demonstrate Antitrust Injury from the Challenged Statutes*

Plaintiffs argue that they proved a *per se* violation of the Sherman Act by showing that "the MSA constructed an output cartel," Appellants' Br. at

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[13] After *Freedom Holdings I* and *Freedom Holdings II*, the Supreme Court articulated a "plausibility" standard for reviewing the dismissal of a complaint. *See Ashcroft v. Iqbal*, 129 S Ct 1937, 1949 (2009) ("[A] complaint must contain sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.'" (quoting *Bell Atl Corp. v Twombly*, 550 U S. 544, 570 (2007)).

57, and the Escrow and Contraband Statutes "conscript[ ] NPMs into the cartel as involuntary members," *id.* at 58. Plaintiffs contend that because they demonstrated such a *per se* violation, they were not required to adduce direct evidence of the challenged statutes' actual anti-competitive effects. *See National Collegiate Athletic Ass'n v. Bd. of Regents of Univ. of Okla.*, 468 U.S. 85, 109 (1984) ("[W]hen there is an agreement not to compete in terms of price or output, 'no elaborate industry analysis is required to demonstrate the anticompetitive character of such an agreement.'" (quoting *National Soc'y of Prof'l Eng'rs v. United States*, 435 U.S. 679, 692 (1978)). Even if such evidence were required, plaintiffs submit that they proved that the MSA has eliminated NPM competition, has preserved the market share of participating manufacturers, and has allowed participating manufacturers to maintain supra-competitive prices.

At the outset, we note that plaintiffs do not challenge the MSA directly in making their *per se* argument. Nor could they. Section 16 of the Clayton Act affords injunctive relief only to plaintiffs who suffer "threatened loss or damage by a violation of the antitrust laws." 15 U.S.C. § 26. While a conspiracy among MSA participating manufacturers to fix prices or to divide the cigarette market among themselves would certainly violate the antitrust laws, *see United States v. Topco Assocs., Inc.*, 405 U.S. 596 (1972); *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150 (1940), such a violation would not threaten plaintiffs with loss or damage. To the contrary, if NPMs are not penalized for increasing market share, they can main-

tain lower prices and thereby benefit from the alleged anti-competitive effects of the MSA. *See Sanders v. Brown*, 504 F.3d 903, 911 (9th Cir. 2007) ("If the OPMs really are charging artificially high prices, and thus making artificially high profits, an NPM conceivably could compete on price by charging a 'normal' price and still make a 'normal' profit, even taking the escrow payment into account."). Thus, because the law is well established that competitors lack standing to challenge a conspiracy by their rivals to raise their own prices, *see Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328, 337 (1990); *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 582-83 (1986), in analyzing plaintiffs' appeal from the trial judgment, we ask whether they proved a *per se* antitrust injury attributable to the challenged statutes.[14]

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[14] The district court suggested that this rule is limited to antitrust plaintiffs who seek treble damages under section 4 of the Clayton Act, 15 U S C § 15, and that standing analysis is more flexible when an antitrust plaintiff seeks injunctive relief. *See Freedom Holdings VI*, 592 F. Supp 2d at 693-95 We disagree.

In the antitrust context, courts have articulated several "efficient enforcer" factors to avoid the "duplicative recoveries" that would result from allowing "every person tangentially affected by an antitrust violation" to sue for treble damages. *Blue Shield of Va v. McCready*, 457 U S. 465, 475-77 & n 11 (1982); *see also Hawaii v. Standard Oil Co* , 405 U S 251, 262 n.14 (1972), *Daniel v. Am. Bd of Emergency Med* , 428 F.3d 408, 443-44 (2d Cir 2005) Because "one injunction is as effective as 100, and, concomitantly, . . 100 injunctions are no more effective than one," *Hawaii v. Standard Oil Co.*, 405 U.S. at 261, some of these factors are "not

b. *Plaintiffs' Failure To Prove that the Challenged Statutes Establish a Hybrid Restraint of Trade*

Because section 1 of the Sherman Act proscribes only private party "contract[s], combination[s] . . . or conspirac[ies] in restraint of trade," 15 U.S.C. § 1, the threshold question at trial was whether the challenged statutes are unilateral acts of a state falling outside federal antitrust law. As the

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relevant" in suits for injunctive relief, *Cargill, Inc. v. Monfort of Colo., Inc.*, 479 U.S. 104, 111 n.6 (1986).

But suits for injunctive relief, no less than suits for damages, require a plaintiff to demonstrate an "injury in fact." *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560 (1992). Morever, an antitrust plaintiff—whether seeking relief in law or equity—must demonstrate "antitrust injury," the more subtle details of which are not relevant here. *See Cargill, Inc. v. Monfort of Colo., Inc.*, 479 U.S. at 113, *see also Zenith Radio Corp. v. Hazeltine Research, Inc.*, 395 U.S. 100, 130 (1969) (holding that plaintiff "need only demonstrate a significant threat of injury from an impending violation of the antitrust laws"), *Paycom Billing Servs., Inc. v. Mastercard Int'l, Inc.*, 467 F.3d 283, 290 (2d Cir. 2006). *Matsushita* holds that a "conspiracy by petitioners to charge higher than competitive prices . . . *could not injure* . . . competitors, [who] stand to gain from any conspiracy to raise the market price." 475 U.S. at 583 (emphasis added). We construe this categorical pronouncement to apply equally to suits at law and equity. *See generally Local Beauty Supply, Inc. v. Lamaur, Inc.*, 787 F.2d 1197, 1204 (7th Cir. 1986) (applying *Matsushita* rule in concluding that plaintiffs seeking equitable relief must also show "antitrust injury"). As the Supreme Court has observed, "[i]t would be anomalous . . . to read the Clayton Act to authorize a private plaintiff to secure an injunction against a threatened injury for which he would not be entitled to compensation if the injury actually occurred." *Cargill, Inc. v. Monfort of Colo., Inc.*, 479 U.S. at 112.

Supreme Court explained in upholding a city ordinance setting rent ceilings in *Fisher v. City of Berkeley*, antitrust laws would prohibit private property owners from "voluntarily band[ing] together to stabilize rents in the city," but the local law involved no "concerted action." 475 U.S. at 266. The Court ruled that "[a] restraint imposed unilaterally by government does not become concerted action within the meaning of the [Sherman Act] simply because it has a coercive effect upon parties who must obey the law." *Id.* at 267. Nor does a government restraint become concerted action because certain citizens benefit from it, *see id.* at 264 ("[T]he function of government may often be to tamper with free markets, correcting their failures and aiding their victims . . . ."), or even have urged it, *cf. City of Columbia v. Omni Outdoor Adver., Inc.*, 499 U.S. 365, 375 (1991) (recognizing inevitability and desirability of public officials acting in response to private citizens' requests in rejecting argument for narrowing state action immunity).

As we recognized in *Freedom Holdings I*, however, there is a distinction between laws whose restraints are the product of unilateral state action and those whose restraints are "hybrid." 357 F.3d at 223-24 & n.17 (citing, *e.g.*, *Fisher v. City of Berkeley*, 475 U.S. at 267-68). Hybrid restraints result when legislation confers a degree of regulatory power on private parties. *See Fisher v. City of Berkeley*, 475 U.S. at 268; *Rice v. Norman Williams Co.*, 458 U.S. at 665 n.1 (Stevens, J., concurring in judgment). Thus, statutes that effectively mandate resale price maintenance have been preempted by federal antitrust law as hybrid

restraints of trade. *See 324 Liquor Corp. v. Duffy*, 479 U.S. at 340 (invalidating New York retail pricing system that "permits wholesalers to set retail prices, and retail markups, without regard to actual retail costs"); *California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. at 103 (invalidating legislation under which "wine producer holds the power to prevent price competition by dictating the prices charged by wholesalers"); *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 U.S. 384, 386 (1951) (invalidating Louisiana law providing that buyer would not resell except at price stipulated by vendor).[15]

On their face, the New York Escrow and Contraband Statutes mandate and enforce payments that, as in *Fisher*, are "unilaterally imposed by government . . . to the exclusion of private control." 475 U.S. at 266. The Escrow Statute requires cigarette manufacturers to make per-cigarette payments to the state according to a statutorily specified formula. *See* N.Y. Pub. Health Law § 1399-pp(2)(a).[16] The Contraband

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[15] At the time these cases were decided, resale price maintenance was a *per se* violation of the Sherman Act *See Dr Miles Med Co v. John D Park & Sons Co*, 220 U S 373 (1911) Recently, the Supreme Court overruled *Dr Miles* and held that resale price maintenance agreements should be judged under the rule of reason *See Leegin Creative Leather Prods., Inc v. PSKS, Inc*, 551 U S at 907 We need not here decide whether state-mandated resale price maintenance would survive preemption analysis after *Leegin*. *See* Areeda & Hovenkamp, *supra*, ¶ 217.1, at 7-9 (Supp 2008) We cite the cases only as illustrative of hybrid restraints

[16] We recognize that NPM payments are released from the state escrow fund to the extent they exceed payments that an NPM would have made if it had joined the MSA as

Statute enforces these payment obligations by requiring cigarette manufacturers to certify their compliance with the Escrow Statute. *See* N.Y. Tax Law § 480-b(1). If no such certification is made, various state-imposed penalties follow. *See id.* §§ 480-b(2), 481(1)(c), 1846. None of these challenged provisions grants any regulatory control to private parties.

In reversing the dismissal of plaintiffs' complaint, we nevertheless concluded that plaintiffs stated a possible claim that the challenged statutes functioned as a hybrid restraint. *See Freedom Holdings I*, 357 F.3d at 216, 223-24. In doing so, we credited, as we were then required to do, plaintiffs' allegation that "the function of the Escrow Statute is to coerce NPMs to join the MSA because the costs of compliance with the Escrow Statute are substantially higher than the costs of being an SPM." *Freedom Holdings II*, 363 F.3d at 152; *see* Compl. ¶ 20; Second Supp. & Am. Compl. ¶ 17. We concluded that proof of this allegation could, in turn, support an inference that the challenged statutes required a cigarette manufacturer "to become part of the market-sharing agreement set up by the MSA—i.e. it must not gain market

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an SPM. *See* N.Y. Pub. Health Law § 1399-pp(2)(b)(ii). Assuming *arguendo* that the MSA does penalize gains in SPM market share, *see Freedom Holdings II*, 363 F.3d at 153, an argument might be made that this release provision penalizes similar gains in NPM market share and, therefore, evidences a hybrid restraint, *see KT&G Corp. v. Attorney Gen. of Okla.*, 535 F.3d 1114, 1130-31 (10th Cir. 2008). Like the Tenth Circuit, however, we think that such a connection to the conduct of private parties "is too attenuated for this court to conclude that [the state has] delegated regulatory power to . . . private individuals." *Id.* at 1131.

share and it therefore cannot compete on price." *Freedom Holdings II*, 363 F.3d at 154. In sum, because the challenged statutes were alleged to force NPMs to join the MSA—which we assumed, at the pleading stage, discouraged participating manufacturers from gaining market share and competing on price—we concluded that plaintiffs might prove that the statutes operated as a hybrid "delegat[ion of] price-setting authority to the OPMs." *Freedom Holdings II*, 363 F.3d at 155.

On review of a challenged trial judgment, our focus necessarily shifts from what plaintiffs might plausibly prove to what the district court found they did—or did not—prove. Consistent with our obligation to view the evidence in the light most favorable to the challenged judgment, we accord great deference to the district court's resolution of evidentiary conflicts, its choices among competing inferences to be drawn from the evidence, and its decision as to what weight to assign particular evidence. *See Anderson v. Bessemer City*, 470 U.S. 564, 573-74 (1985) ("In applying the clearly erroneous standard to the findings of a district court sitting without a jury, appellate courts must constantly have in mind that their function is not to decide factual issues *de novo*. If the district court's account of the evidence is plausible in light of the record viewed in its entirety, the court of appeals may not reverse it even though convinced that had it been sitting as the trier of fact, it would have weighed the evidence differently." (internal quotation marks and citation omitted)); *accord Siewe v. Gonzales*, 480 F.3d 160, 167-68 (2d Cir. 2007). Plaintiffs cannot secure reversal simply by demonstrating that the evidence could support

inferences favorable to their claim. Rather, they must show that the evidence permitted no other inferences. *See Anderson v. Bessemer City*, 470 U.S. at 574 (holding that "[w]here there are two permissible views of the evidence, the factfinder's choice between them cannot be clearly erroneous").

(1) *Plaintiffs' Failure To Prove that the Challenged Statutes Compelled NPMs To Join the MSA*

The district court found that plaintiffs failed at trial to prove the linchpin of their hybrid restraint claim, *i.e.*, that the severity of the escrow payments established by the challenged statutes coerced NPMs to join the allegedly anticompetitive MSA. Plaintiffs initially submitted that the relative severity of escrow payments was established by the fact that, unlike MSA payments, "they are non-deductible for tax purposes." Second Supp. & Am. Compl. ¶ 17; *see Freedom Holdings II*, 363 F.3d at 152. At trial, the district court found that escrow payments would be tax deductible if NPMs disclaimed their rights to interest and release. *See Freedom Holdings VI*, 592 F. Supp. 2d at 697; *see also Freedom Holdings III*, 447 F. Supp. 2d at 238-39. Plaintiffs do not challenge this determination on appeal.

Instead, they submit that the district court erred in further finding that NPMs not only do not pay substantially more under the Escrow Statute than they would pay if they joined the MSA; they pay *less*. *See Freedom Holdings VI*, 592 F. Supp. 2d at 691 (finding that, for sales above grandfa-

thered thresholds, SPMs pay more than NPMs). Plaintiffs' attack is two-fold.

First, plaintiffs fault the district court for relying on data reflecting OPM settlement payments nationwide, rather than data limited to states that joined the MSA. Plaintiffs assert that by including payments made to the four states that settled tobacco litigation before the MSA was executed, the data relied on by the district court inflated the cost of OPM payments by an aggregate of $1-2 billion per year. Specifically, plaintiffs contend that, in 2007, OPMs paid only $4.04 per carton to comply with the MSA, not $5.31 as found by the district court.

Second, plaintiffs submit that the data relied on by the district court was inflated because it included payments owed—but not paid—by SPMs and, further, failed to take into consideration smuggled cigarettes not reported by participating manufacturers. Plaintiffs assert that, between 2003 and 2008, SPMs have failed to pay approximately 13% of payments required by the MSA, either because those payments are disputed or because SPMs have simply defaulted on their MSA obligations.

Neither of these arguments persuades us that the district court committed clear error in rejecting plaintiffs' claim that the escrow payments coerce NPMs to join the MSA. A comparison of MSA and escrow payments is complicated by the fact that the former are calculated based on relative market share while the latter are based on a per-cigarette fee. *See Freedom Holdings III*, 447 F. Supp. 2d at 238. Nevertheless, plaintiffs' contention that OPMs paid only $4.04 per carton—

compared to NPMs' escrow payment of $5.02 per carton—does not find support even in the data on which they rely. That data indicates that OPMs paid $4.52 per carton to comply with the MSA. Further, although plaintiffs fault the district court for adding $0.78 to the $4.52 figure to reflect OPMs' payments to the four states that settled outside the MSA, the alternative of dividing OPMs' payments to the MSA settling states by cigarettes sold nationwide appears even less reliable. Also, while it is undisputed that some SPMs have not fully met their payment obligations under the MSA, the weight to be accorded this fact is debatable given that a number of NPMs appear also to have failed to satisfy their escrow obligations.

In these circumstances, the district court did not clearly err in finding that plaintiffs failed to carry their burden of proving that they were required to pay so much more under the escrow statutes than under the MSA that the challenged statutes effectively compelled them to join the MSA.

(2) *Plaintiffs' Failure To Prove that the Challenged Statutes Delegate Price-Setting Authority to OPMs*

Plaintiffs submit that the challenged statutes nevertheless effect a hybrid restraint of trade because they maintain the higher cigarette prices set by manufacturers participating in the MSA. The record evidence did not compel the district court to so find.

There is no doubt that escrow fees were designed to neutralize the cost disadvantage expe-

rienced by MSA participants vis-à-vis NPMs. *See* MSA § IX(d)(2)(E). But that is hardly sufficient to demonstrate that the challenged statutes mandate or authorize MSA participants to exercise "unsupervised private discretion" to fix prices or to penalize gains in market shares. I Areeda & Hovenkamp, *supra*, ¶ 217b, at 356; *see generally Massachusetts Food Ass'n v. Mass. Alcoholic Beverages Control Comm'n*, 197 F.3d at 565 ("What is centrally forbidden is state licensing of arrangements between private parties that suppress competition—not state directives that *by themselves* limit or reduce competition." (emphasis in original)). Rather, as the district court correctly concluded, the statutes' effort to impose a roughly equivalent cost on NPMs to that borne by manufacturers participating in the MSA can be analogized to the imposition of a flat tax.

A tax increase, like any cost, will likely be passed on to consumers in the form of higher prices, but where, as here, the state alone imposes the increased cost, there is no private collusion implicating the antitrust laws. *See Freedom Holdings VI*, 592 F. Supp. 2d at 699 (citing *Freedom Holdings I*, 357 F.3d at 229, and *Freedom Holdings II*, 363 F.3d at 152). That competitors respond in similar ways to a tax they must all pay does not, by itself, manifest an agreement proscribed by the Sherman Act. *See Brooke Grp. Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 227 (1993) (holding that "tacit collusion" of participants in oligopolistic market to raise prices in response to higher costs is "not in itself unlawful"); *Williamson Oil Co. v. Philip Morris U.S.A.*, 346 F.3d 1287, 1314-15 (11th Cir. 2003) (explain-

ing why lock-step price increases following MSA were insufficient evidence of price-fixing); *see generally* Donald F. Turner, *The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusals To Deal*, 75 Harv. L. Rev. 655, 663 (1962) ("[C]onscious parallelism is devoid of anything that might reasonably be called agreement when it involves simply the independent responses of a group of competitors to the same set of economic facts . . . .").

In any event, the district court did not reject plaintiffs' price fixing argument simply in theory. It found it belied in fact by substantial testimonial and documentary evidence indicating that, even under the challenged statutes, NPMs have retained pricing autonomy, which they have exercised to gain substantial market share at the expense of OPMs. *See Freedom Holdings VI*, 592 F. Supp. 2d at 698-99.

In urging us to identify factual error, *see* Appellant's Br. at 26-27 (maintaining that "Enforcement Statutes ha[ve] succeeded in crushing the NPMs"), plaintiffs submit that the district court's market share findings were clearly erroneous because Pricewaterhouse Coopers based these calculations, like its MSA payment data, on national market share without distinguishing between states that joined in the MSA and states that reached independent settlements. Plaintiffs cite data suggesting that amendments to the allocable share release provision of state escrow statutes have resulted in declining NPM market share since it peaked at 8.1% in 2003. This is not surprising as such amendments require NPMs to make escrow payments on a greater percentage of cigarettes

sold than previously. Further, the district court reasonably determined that the 2004 decision by General Tobacco, the largest NPM, to join the MSA also explains the expansion of SPMs' total market share at the expense of the NPMs in the years thereafter. *See Freedom Holdings VI*, 592 F. Supp. 2d at 691 n.5. In any event, even if allocable share amendments have eroded the dramatic market share gains that NPMs realized in the immediate aftermath of the MSA, the same data indicates that NPMs have gained considerable overall market share from the 0.4% held at the time the MSA went into effect to the 5.4% held in 2007.

In short, we identify no error in the district court's determination that the allegations we accepted for purposes of reviewing the dismissal of plaintiffs' complaint—that the challenged statutes forced NPMs "to become part of the market-sharing agreement set up by the MSA," where OPMs fixed and maintained inflated prices and penalized gains in market share, *Freedom Holdings II*, 363 F.3d at 154—were not proved by plaintiffs at trial. Rather, we conclude that substantial evidence supported the district court's conclusion that the challenged New York statutes, although in furtherance of the MSA, do not manifest a hybrid restraint of trade because they do not mandate or authorize any private party to exercise anticompetitive regulatory authority. This decision is consistent with those of our sister circuits who have similarly rejected antitrust challenges to state escrow statutes in furtherance of the MSA. *See Xcaliber Int'l Ltd. v. Attorney Gen. of La.*, 612 F.3d 368, 374-77 (5th Cir. 2010) (rejecting

challenge to Louisiana statute); *Grand River Enters. Six Nations, Ltd. v. Beebe*, 574 F.3d 929, 936-39 (8th Cir. 2009) (rejecting challenge to Arkansas statute), *cert. denied*, 130 S. Ct. 2095 (2010); *KT&G Corp. v. Attorney Gen. of Okla.*, 535 F.3d 1114, 1128-33 (10th Cir. 2008) (rejecting challenge to Kansas and Oklahoma statutes); *Sanders v. Brown*, 504 F.3d at 910-11 [9th Cir.] (rejecting challenge to California statutes), *cert. denied*, 128 S. Ct. 2427 (2008); *Tritent Int'l Corp. v. Kentucky*, 467 F.3d 547, 554-58 (6th Cir. 2006) (rejecting challenge to Kentucky statutes). *But cf. A.D. Bedell Wholesale Co. v. Philip Morris Inc.*, 263 F.3d 239, 247-54 (3d Cir. 2001) (holding MSA *per se* illegal output restriction, but defendants immune under *Noerr-Pennington* doctrine), *cert. denied*, 534 U.S. 1081 (2002).

We emphasize, however, the limited scope of our decision. Because plaintiffs have not proved that the challenged statutes coerce them to join the MSA or that the MSA otherwise injures them, they lack standing to challenge provisions of the MSA that they allege constitute an illegal agreement to divide the cigarette market among participating manufacturers. *See Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. at 582-83. Thus, we have no occasion here to consider whether the MSA constitutes a private agreement that impermissibly restrains trade by penalizing SPMs when *they* gain market share from OPMs. *See Freedom Holdings II*, 363 F.3d at 153; *Freedom Holdings VI*, 592 F. Supp. 2d at 698 & n.15; *Freedom Holdings III*, 447 F. Supp. 2d at 258. Nor need we address defendants' arguments that MSA payments "do not change *materially* based on vol-

ume sold" or that the SPM payment formula "maintains a *largely* constant per-carton payment no matter how much market share the SPMs acquire." Appellees' Br. at 39 n.9 (emphasis added). We hold simply, in light of the district court's findings, that plaintiffs failed to prove that the challenged statutes granted regulatory power to private parties in violation of the antitrust laws that caused plaintiffs any injury.

2. *The Sherman Act Does Not Apply to the Challenged Statutes Because They Manifest "State Action"*

In *Parker v. Brown*, 317 U.S. 341, the Supreme Court construed the Sherman Act to proscribe only private, not state, action. Because the Court grounded its ruling in the absence of a clear statutory statement of Congress's intent to preempt state regulation, *see id.* at 351, courts and commentators have concluded that the decision rests on "principles of federalism and state sovereignty," *Patrick v. Burget*, 486 U.S. 94, 99 (1988); *see also* IA Areeda & Hovenkamp, *supra*, ¶ 221b, at 48 (noting that *Parker* "was deemed necessary to protect the states' coordinate role in government"). Thus, "the premise of *Parker v. Brown* is that federal courts in applying the antitrust laws, should assume that Congress accepted the risks of state-authorized displacement of competition." *Cine 42nd St. Theater Corp. v. Nederlander Org., Inc.*, 790 F.2d 1032, 1049 (2d Cir. 1986) (Newman, J., concurring) (citation omitted).

Parker cautioned, however, that a state cannot "give immunity to those who violate the Sherman Act by authorizing them to violate it, or by declar-

ing that their action is lawful." 317 U.S. at 351. In its simplest form, this means that "a state cannot shield private parties from the federal antitrust laws by enacting a statute saying no more than that [competitors] may agree to fix prices." *Massachusetts Food Ass'n v. Mass. Alcoholic Beverages Control Comm'n*, 197 F.3d at 563-64. As Justice Powell famously stated, "[t]he national policy in favor of competition cannot be thwarted by casting such a gauzy cloak of state involvement over what is essentially a private price-fixing arrangement." *California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. at 106.

From these principles, we can conclude that a state's own actions are not subject to antitrust preemption. *See Hoover v. Ronwin*, 466 U.S. 558, 568 (1984). But when private parties participate in anti-competitive conduct purportedly authorized by state action, a closer question arises. *See id.*; *FTC v. Ticor Title Ins. Co.*, 504 U.S. 621, 633 (1992). Such conduct is shielded from antitrust liability only if it is "clearly articulated and affirmatively expressed as state policy" and "actively supervised by the State itself." *California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. at 105 (internal quotation marks omitted).

Our conclusion that plaintiffs failed to prove that New York's Escrow and Contraband Statutes authorize Sherman Act violations obviates the need for detailed analysis of whether their alleged anti-competitive aspects are clearly articulated, affirmatively expressed, or actively supervised. *See Freedom Holdings I*, 357 F.3d at 223; IA Areeda & Hovenkamp, *supra*, ¶ 221a, at 42.

Indeed, *Hoover* suggests that "anticompetitive conduct performed entirely by state actors, without any private involvement, . . . effectively satisfie[s] the *Midcal* supervision requirement." *Freedom Holdings I*, 357 F.3d at 232 n.27. A number of our sister circuits have relied on *Hoover* to hold that the MSA and statutes enacted in furtherance of it constitute unilateral state action exempt from the application of the antitrust laws. *See Xcaliber Int'l Ltd. v. Attorney Gen. of La.*, 612 F.3d at 378-80 & n.11 [5th Cir.]; *Grand River Enters. Six Nations, Ltd. v. Beebe*, 574 F.3d at 939-41 [8th Cir.]; *Sanders v. Brown*, 504 F.3d at 914-19 [9th Cir.]. While we generally agree with this approach, we nevertheless apply the *Midcal* test "out of an abundance of caution" to explain why we reject plaintiffs' argument that the district court erred in finding the challenged statutes to constitute state action immune from antitrust preemption. *Costco Wholesale Corp. v. Maleng*, 522 F.3d 874, 888 (9th Cir. 2008).

At the outset, we observe that the nature of the clear articulation and active supervision required by *Midcal* necessarily varies with the nature of the challenged restraint. Thus, state authorization is sufficiently clear when "the legislature contemplated the kind of action" challenged. *City of Lafayette v. La. Power & Light Co.*, 435 U.S. 389, 415 (1978) (plurality opinion) (internal quotation marks omitted). Likewise, "the active supervision requirement mandates that the State exercise ultimate control over the challenged anticompetitive conduct." *Patrick v. Burget*, 486 U.S. at 101. When, in *Freedom Holdings I*, we concluded that New York had not sufficiently articulated "why

the market-share provisions are needed to effectuate state policy goals," 357 F.3d at 228, or actively supervised "the pricing decisions within the allegedly-anticompetitive market structure enforced by the Contraband Statutes," *id.* at 231, we relied on plaintiffs' allegations that the challenged statutes coerced NPMs into joining the MSA, under which OPMs exercised effective authority to fix prices and control market shares. Because plaintiffs failed to prove these allegations at trial, however, their claim reduces to a challenge to what is effectively a flat tax whose only arguably "anti-competitive" effect is to raise cigarette prices.

a. *The Creation of an Escrow Fund and Enforcement of Payment Obligations Are Clearly Articulated and Affirmatively Expressed as State Policy*

Midcal's clear articulation/affirmative expression requirement "ensure[s] that state action immunity is afforded only to actions taken by the state." *Id.* at 227. In *Freedom Holdings I*, we easily concluded that the entire MSA scheme satisfied this requirement because "agreement to the MSA by the New York Attorney General, approval of it by a New York court, and passage of the [Escrow and] Contraband Statutes were express acts of the State of New York." *Id.* (footnote omitted). At the same time, we suggested that the requirement also serves the "ancillary purpose" of revealing whether "the State's policy goals are sufficient to qualify for the *Parker* immunity," observing that "simply protecting private parties

from competition is not a sufficient goal." *Id.* at 227 (citing *Parker v. Brown*, 317 U.S. at 351-52). Although we did not think that matter could be resolved at the pleading stage, *see id.* at 216, we doubted "that a federal court would upset a state statute solely because it failed to meet the explanatory aspect of the first *Midcal* prong," *id.* at 227. Indeed, we later clarified that our initial rejection of state action immunity in *Freedom Holdings I* "expressly relied on the challenged scheme's failure to meet the second *Midcal* prong." *Freedom Holdings II*, 363 F.3d at 157.

Now, after trial, with plaintiffs having failed to prove that the challenged statutes operated as anything more than a flat tax, we can conclude that the record permitted the district court to find even the ancillary purpose of the first *Midcal* requirement satisfied.[17] As we observed in *Freedom Holdings I*, a flat tax, far from "shelter[ing] private parties from the Sherman Act solely in order [for the state] to share monopoly profits," 357 F.3d at 230, would bear a sufficient nexus to policy goals of deterring smoking and raising revenue for tobacco-related health expenses to justify *Parker* immunity, *see id.* at 229. These goals are

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[17] We have no occasion to consider whether, to the extent a different plaintiff might have standing to challenge the MSA as distinct from the Escrow and Contraband Statutes, New York could offer a justification for any alleged market division among MSA participants to satisfy the ancillary purpose of the first *Midcal* requirement *See Freedom Holdings III*, 447 F. Supp 2d at 258 (observing that "increased marginal costs to the SPMs above the grandfathered levels can be viewed as a means of recouping those funds which were lost to the states through the grandfather provision")

expressly articulated in the Escrow Statute, which references the "serious public health concerns" posed by cigarettes, N.Y. Pub. Health Law § 1399-nn(1); the "serious financial concerns for the state" in having to fund related health-care programs, *id.* § 1399nn(2)-(4); and the MSA requirement that cigarette manufacturers "pay substantial sums to the state," *id.* § 1399-nn(5). Thus, the state determined that it was in its interest "to require that [NPMs] establish a reserve fund to guarantee a source of compensation [for cigarette-related injuries caused by their products] and to prevent such manufacturers from deriving large, short-term profits and then becoming judgment-proof before liability may arise." *Id.* § 1399-nn(6). There is a sufficient nexus between these identified purposes and the required escrow payments to preclude us from second-guessing the state's choice of means to achieve its articulated policy. *See Freedom Holdings I*, 357 F.3d at 229; *accord Massachusetts Food Ass'n v. Mass. Alcoholic Beverages Control Comm'n*, 197 F.3d at 565; *cf. Freedom Holdings II*, 363 F.3d at 156 (questioning state's ability to refute hypothetical antitrust challenge to statute authorizing price fixing of car washes by assertion that law would improve performance of state symphony).

Plaintiffs do not dispute that the challenged statutes clearly articulate and affirmatively express state policy. Nor do they challenge the state's ability to pass laws addressing health concerns associated with smoking. Rather, they submit that defendants cannot satisfy the ancillary explanatory purpose of *Midcal* because the MSA requires states to become "active participants in

the cartel." Appellants' Br. at 68. Specifically, they contend that the NPM adjustment, which provides a substantial incentive for states to pass escrow laws, removes the challenged statutes from the scope of *Parker* immunity. We disagree.

In *Parker*, the Supreme Court observed that there was "no question of the state or its municipality becoming a participant in a private agreement or combination by others for restraint of trade," and that the challenged statute "made no contract or agreement and entered into no conspiracy in restraint of trade or to establish monopoly." 317 U.S. at 351-52. While some courts had read this language to establish an exception to *Parker* immunity when private parties "conspired" with the government to pass laws restraining trade, *see, e.g.*, *Whitworth v. Perkins*, 559 F.2d 378 (5th Cir. 1977), the Supreme Court has since foreclosed this argument by holding that "[t]here is no such conspiracy exception," *City of Columbia v. Omni Outdoor Adver., Inc.*, 499 U.S. at 374-75 (observing that quoted language from *Parker* "should not be read to suggest the general proposition that even governmental *regulatory* action may be deemed private—and therefore subject to antitrust liability—when it is taken pursuant to a conspiracy with private parties" (emphasis in original)). The Supreme Court observed that "[t]he impracticality of such a principle is evident if, for purposes of the exception, 'conspiracy' means nothing more than an agreement to impose the regulation in question." *Id.* at 375. Here, the NPM adjustment reflects, at most, the sort of agreement to take *regulatory* action that the Supreme Court has held insufficient, by itself, to deprive state

action of *Parker* immunity. *See also id.* at 376 (rejecting proposed exceptions to state action immunity even for government "corruption" or "abandonment of public responsibilities to private interests").

Perhaps recognizing that *City of Columbia* precludes our recognition of a conspiracy exception, plaintiffs urge us to conclude that the settling states, through the MSA, "engage[d] in interstate commerce as commercial participants." Appellants' Reply Br. at 27. While the possibility of a market participant exception is left open in *City of Columbia*, 499 U.S. at 374-75, 379, the trial record does not support its application here. New York neither manufactures nor distributes cigarettes in the market. *See id.* at 374-75; *cf.* IA Areeda & Hovenkamp, *supra*, ¶ 221, at 49 (noting that *City of Columbia* suggests that private price-fixing conspiracy "is not immunized because one of the producers is state-owned"). New York simply regulates certain manufacturers, requiring them to make specified payments so that "the state will have an eventual source of recovery from them if they are proven to have acted culpably." N.Y. Pub. Health Law § 1399-nn(6). Whatever the policy arguments for or against such legislation, it does not render the state a market participant subject to antitrust liability.

b. *The Flat Tax Imposed and Enforced by the Challenged Statutes Is Actively Supervised by the State*

Having concluded that the challenged statutes are clearly articulated and affirmatively expressed

as state policy, we now consider whether they are actively supervised by the state. In *Freedom Holdings I*, we concluded that the state could not satisfy this requirement at the pleading stage because "[n]either the New York statutes, the MSA, nor any other New York law or regulation 'actively supervise[s]' the pricing decisions within the allegedly-anticompetitive market structure enforced by the Contraband Statutes." 357 F.3d at 231 (second alteration in original); *accord Freedom Holdings II*, 363 F.3d at 157 (observing that it was "too soon to say whether the state will ultimately be able to elicit evidence sufficient to meet this second prong"). We now consider the state's supervision of the challenged statutes in light of plaintiffs' trial failure to prove that the challenged statutes impose anything more anti-competitive than a flat tax on NPMs, and we conclude that the district court reasonably found the second *Midcal* requirement satisfied.

The active supervision required to secure state action immunity necessarily depends on the facts of each case. As noted *supra* at [52-53], the laws challenged in *Midcal* and *324 Liquor* effectively allowed one private party to set the prices charged by another private party. *See 324 Liquor Corp. v. Duffy*, 479 U.S. at 340; *California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. at 103. Thus, the Supreme Court's determination that the state did not actively supervise the challenged programs in those cases relied on the fact that the state "'neither establishes prices nor reviews the reasonableness of the price schedules.'" *324 Liquor Corp. v. Duffy*, 479 U.S. at 345 (quoting *California Retail Liquor Dealers Ass'n v.*

Midcal Aluminum, Inc., 445 U.S. at 105). By contrast, in this case, the state itself determines the increased cost to NPMs attributable to escrow payments. *See* N.Y. Pub. Health Law § 1399-pp(2).

This case is thus more akin to the situation distinguished by the Court in *324 Liquor Corp.*, when it observed that a "simple 'minimum markup' statute . . . may satisfy the 'active supervision' requirement." 479 U.S. at 344 n.6. In support, the Court cited *Morgan v. Division of Liquor Control*, 664 F.2d 353 (2d Cir. 1981), in which this court upheld Connecticut's alcohol markup statute. In *Morgan*, we emphasized that the active supervision test was met by the state's "structuring a detailed mechanism for determining prices for alcoholic beverages." *Id.* at 356. The critical difference then is that, in one case, a private party sets the minimum resale price (without state input or supervision) while, in the other, the state supplants normal market mechanisms only to the extent it mandates the markup. In the latter circumstance, "although the hypothetical statute could eliminate price competition among retailers, that would result from the choice of the state rather than from the choice of the wholesaler. Similarly, the amount of the minimum markup would be determined by the state, not by the wholesaler . . . . Accordingly, there would be nothing to supervise." IA Areeda & Hovenkamp, *supra*, ¶ 226e, at 194; *see also Costco Wholesale Corp. v. Maleng*, 522 F.3d at 899 (upholding minimum markup on this ground).

Here, plaintiffs' antitrust argument reduces to a claim that the challenged statutes, by raising their costs, have the effect of raising cigarette

prices. It is undeniably the state, however, that determines the cost increase by fixing the required escrow payments. *See, e.g.*, N.Y. Pub. Health Law § 1399-pp(2)(a)(v) (requiring NPMs to contribute "for each of 2007 and each year thereafter: $.0188482 per unit sold"); *cf. Morgan v. Div. Liquor Control*, 664 F.2d at 356 (referencing state's "detailed mechanism for determining prices"). Thereafter, normal market mechanisms function. Indeed, as plaintiffs acknowledged at oral argument, NPMs can charge whatever price they wish, as long as they make the specified escrow payments. Thus, like the hypothetical minimum markup in *324 Liquor*, the increase in cigarette prices attributable to the challenged statutes "result[s] from the choice of the state rather than from the choice of" cigarette manufacturers. IA Areeda & Hovenkamp, *supra*, ¶ 226e, at 194. Accordingly, because the statute specifies the exact component of the inflated price attributable to the state, "there is nothing that the state can 'actively supervise' except to see that the statutory requirements are obeyed—and there is no claim that the state has neglected this." *Battipaglia v. N.Y. State Liquor Auth.*, 745 F.2d 166, 176 (2d Cir. 1984) (Friendly, J.); *see also* IA Areeda & Hovenkamp, *supra*, ¶ 226e, at 194.

Plaintiffs do not dispute that the state has engaged in this form of supervision. Indeed, the record shows that the state (1) reviews audit reports detailing the competitive effects of the MSA and challenged statutes, and (2) has responded to these reports by enacting (a) the Contraband Statute and (b) the allocable share release amendment. Rather, characterizing the

state as an "active participant[ ] in [a] commercial enterprise," plaintiffs maintain that it would be "paradoxical" for us to conclude that the state's active enforcement of the Escrow Statute satisfies the active supervision prong because, they claim, the statute "is the primary tool for insulating the [participating manufacturers] from consumer oriented price competition." Appellants' Reply Br. at 29. We are not persuaded.

As the Supreme Court noted in rejecting a conspiracy exception to *Parker* immunity, "it is both inevitable and desirable that public officials often agree to do what one or another group of private citizens urges upon them." *City of Columbia v. Omni Outdoor Adver., Inc.*, 499 U.S. at 375. Depending on which party's brief one reads, the purpose and effect of the challenged legislation is either to "destroy" NPMs or "to level the playing field." *Compare* Appellants' Br. at 22, *with* Appellees' Br. at 12, 50, 51 n.13. A federal court cannot, however, use the antitrust laws to "second-guess[ ]" clearly articulated, properly supervised state policy judgments. *Freedom Holdings I*, 357 F.3d at 229; *Massachusetts Food Ass'n v. Mass. Alcoholic Beverages Control Comm'n*, 197 F.3d at 565. The purpose of *Midcal* analysis is simply to ascertain "whether anticompetitive conduct engaged in by private parties should be deemed state action" immune from antitrust laws. *Patrick v. Burget*, 486 U.S. at 100. Thus, plaintiffs' intimation that the challenged statutes have harmed them is not relevant to a court's determination of whether it is the state itself that has imposed the very restraint about which they complain and satisfactorily supervised its operation.

See Hoover v. Ronwin, 466 U.S. at 567-68. Accordingly, we conclude that the trial record supports a finding that New York's control and active enforcement of escrow payment obligations satisfies the second *Midcal* requirement.

Once again, we note the limited reach of our ruling, which does not foreclose challenges to other potentially anti-competitive conduct in the tobacco industry. In this regard, our decision is consistent with that of the Third Circuit in *Bedell*, on which *Freedom Holdings I* relied to conclude that the state had not satisfied the active supervision requirement at the pleading stage. The *Bedell* plaintiffs were a class of cigarette wholesalers—not NPMs—who claimed to suffer losses because the major tobacco companies "imposed artificially high prices on direct purchasers." 263 F.3d at 247 (internal quotation marks omitted). The Third Circuit concluded that such plaintiffs had standing to challenge the restraints imposed by the MSA itself, specifically the SPM pricing formula for allegedly penalizing gains in market share. *See id.* In this case, where plaintiffs' claim of antitrust injury derives from the Escrow and Contraband Statutes, *see supra* at [51-52 & n.14], we hold simply that the district court reasonably concluded from the trial evidence that those legislative enactments of state policy neither mandate nor authorize private parties to exercise unsupervised power to restrain trade.

C. *Commerce Clause Claim*

The Constitution's affirmative grant of power to Congress "[t]o regulate Commerce . . . among the several States," U.S. Const. art. I, § 8, cl. 3, has

long been construed to imply a negative counterpart, commonly referred to as the dormant Commerce Clause, restraining state authority over interstate commerce, *see, e.g.*, *United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth*, 550 U.S. 330, 338 (2007); *American Trucking Ass'ns v. Mich. Pub. Serv. Comm'n*, 545 U.S. 429, 433 (2005). In appealing the district court's rejection after trial of their dormant Commerce Clause challenge to New York's Escrow and Contraband Statutes, plaintiffs do not contend—nor could they—that these laws discriminate against interstate commerce either facially or in incidental effect. *See Freedom Holdings I*, 357 F.3d at 217-19; *see also Wyoming v. Oklahoma*, 502 U.S. 437, 454-55 (1992); *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970). Instead, they submit that the district court erred in failing to hold the statutes invalid because the combined extraterritorial effects of (1) forty-six state escrow statutes, (2) forty-four contraband statutes, and (3) forty-four amended allocable share release provisions practically result in national regulation of cigarette prices, which "may not be accomplished piecemeal through the extraterritorial reach of individual state statutes." *Healy v. Beer Inst.*, 491 U.S. 324, 340 (1989); *accord Grand River Enters. Six Nations, Ltd. v. Pryor*, 425 F.3d at 171.[18]

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[18] A court may analyze a claim that a state statute is invalid because it regulates commerce extraterritorially either as a disproportionate burden on commerce under the balancing test set forth in *Pike v Bruce Church, Inc* , 397 U.S. at 142, or, as plaintiffs' claim requires here, "independently . as a question of regulatory jurisdiction rather

In support, plaintiffs rely heavily on our decision in *Grand River*, which recognized a possible claim by a different group of NPMs: "that the practical effect of the challenged statutes and the MSA is to control prices outside of the enacting states." 425 F.3d at 173. We took "no position as to the ultimate viability" of a dormant Commerce Clause challenge to the alleged arrangement. *Id.* Rather, we concluded that "not dismissing this claim at the pleading stage is consistent with the district court's decision to reinstate the Sherman Act claim, which alleged that the MSA and interrelated statutes restrained trade and affected market prices." *Id.* In so holding we noted that the *Grand River* complaint alleged facts not pleaded in *Freedom Holdings I*: "that the [challenged statutes] are inconsistent with the legitimate regulatory regimes of other states, that [they] force out-of-state merchants to seek New York regulatory approval before undertaking an out-of-state transaction, or that any sort of interstate regulatory gridlock would occur if 'many or every' state adopted similar legislation." *Id.* at 171 (quoting *Freedom Holdings I*, 357 F.3d at 221). Although plaintiffs amended their complaint to conform with *Grand River*, they developed little evidence

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than one of regulatory discrimination," *Freedom Holdings I*, 357 F 3d at 216 n 11 (citing *Healy v Beer Inst.*, 491 U.S at 336, and *Edgar v MITE Corp.*, 457 U S 624, 643 (1982) (plurality opinion) ("The limits on a State's power to enact substantive legislation are similar to the limits on the jurisdiction of state courts. In either case, any attempt directly to assert extraterritorial jurisdiction over persons or property would offend sister States and exceed the inherent limits of the State's power" (internal quotation marks omitted))

at trial to support the three allegations noted in that case. Nor do they offer much by way of analysis on appeal as to how the challenged statutes fall into any of the three categories. They simply label state statutes an "interlocking grid" and assume that judicial condemnation will follow under the Commerce Clause. Appellants' Br. at 55, 57; *see also id.* at 5, 53, 56; Appellants' Reply Br. at 3, 6. Like the district court, we are not persuaded.

Two Supreme Court decisions provide useful guidance in reviewing Commerce Clause challenges to "interlocking" state statutes. First, in *Brown-Forman Distillers Corp. v. New York State Liquor Authority*, 476 U.S. 573 (1986), the Court invalidated a provision of New York's Alcoholic Beverage Control Law requiring distillers to affirm that the schedule of prices filed in New York "is no higher than the lowest price at which such item of liquor will be sold . . . anywhere in any other state of the United States" during the month covered by the schedule, *id.* at 576. Under the challenged law, the New York Liquor Authority prohibited payments of promotional allowances to wholesalers, a practice allowed in other states. *See id.* at 577-78. The New York Liquor Authority could "for good cause" permit distillers to change their posted prices. *Id.* at 582 n.5. The Court held that the "practical effect" of the challenged regulatory regime was to "control liquor prices in other States" because, once a distiller posted prices in New York, it could not lower prices elsewhere in the country without obtaining New York's "regulatory approval." *Id.* at 582-83. Further, the Court noted that "the proliferation of state affirmation

laws . . . has greatly multiplied the likelihood that a seller will be subjected to inconsistent obligations in different States." *Id.* at 583. Because New York's position on promotional payments was inconsistent with that of other states, New York effectively forced Brown-Forman "to abandon its promotional allowance program in States in which that program is legal." *Id.* at 584.

In *Healy v. Beer Institute*, 491 U.S. 324, the Supreme Court invalidated a Connecticut law requiring beer shippers to affirm that their posted prices were no higher than prices in border states. Connecticut further made it unlawful to sell beer in that state at a price higher than that charged in bordering states during the month covered by the posting. *See id.* at 329. The Court held that "the practical effect of the statute must be evaluated not only by considering the consequences of the statute itself, but also by considering how the challenged statute may interact with the legitimate regulatory regimes of other States and what effect would arise if not one, but many or every, State adopted similar legislation." *Id.* at 336. Noting that Massachusetts required brewers to post prices a month before they took effect, the Supreme Court concluded that the Connecticut law had the practical effect of requiring a brewer "on January 1, when [he] posts his February prices for Massachusetts, [to] take account of the price he hopes to charge in Connecticut during the month of March." *Id.* at 338. If the border states "each enacted statutes essentially identical to Connecticut's," the problem was only compounded:

> Under those circumstances, in January, when a brewer posts his February prices in Con-

> necticut and the border States, he must determine those prices knowing that the lowest bottle, can, or case price in any State would become the maximum bottle, can, or case price the brewer would be permitted to charge throughout the region for the month of March. This is true because in February, when the brewer posts his March prices in each State, he will have to affirm that no bottle, can, or case price is higher than the lowest bottle, can, or case price in the region—and these "current" prices would have been determined by the January posting. Put differently, unless a beer supplier declined to sell in one of the States for an entire month, the maximum price in each State would be capped by previous prices in the other States. This maximum price would almost surely be the minimum price as well, since any reduction in either State would permanently lower the ceiling in both.

Id. at 339-40. The Court described this scenario as "price gridlock." *Id.* at 340.

Applying these principles to the challenged statutes, we conclude that plaintiffs failed to prove any similar gridlock here. By its terms, the Escrow Statute "taxes" only cigarettes sold in New York. *See* N.Y. Pub. Health Law § 1399-oo(10) (defining "[u]nits sold" for purposes of Escrow Statute as "the number of individual cigarettes sold *in the state*" (emphasis added)); *id.* § 1399-pp(2) (specifying payments "per unit sold"); *see also id.* at § 1399-pp(2)(b)(ii) (releasing payments from escrow "to the extent that a tobacco product manufacturer establishes that the amount it was

required to place into escrow on account of units sold *in the state* in a particular year was greater than the [MSA] payments . . . that such manufacturer would have been required to make on account of *such units sold* had it been a participating manufacturer" (emphasis added)). Similarly, the Contraband Statute applies only to manufacturers "whose cigarettes are sold for consumption *in this state*." N.Y. Tax Law § 480-b(1) (emphasis added). Plaintiffs offered no evidence indicating that the practical effect of either of these statutes reaches beyond their terms to set minimum or maximum cigarette prices outside New York.

We recognize that escrow payments, like any tax, increase the cost of cigarettes. Unlike the statute struck down in *Healy*, however, nothing prevents manufacturers from recouping increased costs imposed by New York law from New York consumers. *See National Elec. Mfrs. Ass'n v. Sorrell*, 272 F.3d 104, 110 (2d Cir. 2001) ("In cases like *Healy*, the state necessarily prevented firms from recouping any of the costs imposed by the state statute from the residents of the state itself. Here, the manufacturers remain free to charge higher prices only to Vermonters without risking violation of the statute."); *see also Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 521 (1935) (Cardozo, J.) (upholding injunction against enforcement of New York milk pricing statute because "New York has no power to project its legislation into Vermont by regulating the price to be paid in that state for milk acquired there"). In short, plaintiffs cannot show that the challenged statutes violate the Commerce Clause by

"depriv[ing] businesses and consumers in other States of 'whatever competitive advantages they may possess' based on the conditions of the local market.'" *Healy v. Beer Inst.*, 491 U.S. at 339 (quoting *Brown-Forman Distillers Corp. v. N.Y. Liquor Auth.*, 476 U.S. at 580); *accord SPGGC, LLC v. Blumenthal*, 505 F.3d 183, 193 (2d Cir. 2007).

Further, while the enactment of similar escrow and contraband statutes in most states has caused cigarette prices to rise nationwide, such statutes impose no inconsistent obligations, which might evidence extraterritorial regulation proscribed by the Commerce Clause. *See Brown-Forman Distillers Corp. v. N.Y. Liquor Auth.*, 476 U.S. at 583; *see also CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 88-89 (1987) (identifying no inconsistency violating dormant Commerce Clause when multiple states regulate voting rights of corporations created under their law). Certainly, plaintiffs point to no provision of New York law requiring cigarette manufacturers to obtain the state's "regulatory approval" before selling or pricing cigarettes in other states. *Brown-Forman Distillers Corp. v. N.Y. Liquor Auth.*, 476 U.S. at 582. Accordingly, plaintiffs failed to prove that the challenged statutes have any impermissible extraterritorial effect.

Grand River is not to the contrary. Drawing all reasonable inferences in those plaintiffs' favor at the pleading stage, we concluded that they had stated a colorable claim "that the practical effect of the challenged statutes and the MSA is to *control* prices outside of the enacting states by tying both the SPM settlement and NPM escrow pay-

ments to national market share, which in turn affects interstate pricing decisions." 425 F.3d at 173 (emphasis added). Such control is not evidenced simply by coincident obligations which may produce parallel price increases among the states. In *Grand River*, however, we suggested that a factfinder might be able to infer control from the fact that the allocable share release provision, which refunds payments made by NPMs in excess of what they would have paid as SPMs under the MSA, might effectively require NPMs to pay a "national-market-share-dependent amount." *Id.* at 172.

Plaintiffs submit that *Grand River* compels us to reverse the district court's Commerce Clause decision because, under the amended allocable share release provision, escrow payments are still keyed, in part, to MSA payments, which in turn depend on national market share. We disagree. Plaintiffs adduced no evidence showing that the amended release provision has ever been invoked. Funds are released from escrow to the extent escrow payments exceed MSA payments, *see* N.Y. Pub. Health Law § 1399-pp(2)(b)(ii), but the district court reasonably found that, in practice, MSA payments exceed escrow payments. In the absence of contrary evidence, the district court was hardly compelled to conclude that NPM escrow payments will actually be released from the state escrow fund in amounts calculated by reference to national market share. *See International Tobacco Partners, Ltd. v. Kline*, 475 F. Supp. 2d 1078, 1090-91 (D. Kan. 2007). Thus, even if such an indirect reference to national market share could, in some cases, raise concerns under the dormant

Commerce Clause, plaintiffs simply have not proved that the challenged statutes have the practical effect of regulating commerce extraterritorially.

Ultimately, plaintiffs' Commerce Clause claim fails, as we said in *Freedom Holdings I*, because "[m]ere 'upstream pricing impact' is not a violation of the dormant Commerce Clause, even if the impact is felt out of state where the stream originates." *Freedom Holdings VI*, 592 F. Supp. 2d at 707 (quoting *Freedom Holdings I*, 357 F.3d at 220). Courts have consistently recognized that "[t]he mere fact that state action may have repercussions beyond state lines is of no judicial significance so long as the action is not within that domain which the Constitution forbids." *Osborn v. Ozlin*, 310 U.S. 53, 62 (1940); *see also Healy v. Beer Inst.*, 491 U.S. at 345 (Scalia, J., concurring) ("[I]nnumerable valid state laws affect pricing decisions in other States."); *National Elec. Mfrs. Ass'n v. Sorrell*, 272 F.3d at 111 (noting that "it is axiomatic that the increased cost of complying with a regulation may drive up the sales price" and rejecting argument that such increased prices evidenced dormant Commerce Clause violation); *National Paint & Coatings Ass'n v. City of Chicago*, 45 F.3d 1124, 1130-31 (7th Cir. 1995) (Easterbrook, J.) (observing that "almost every state and local law—indeed, almost every private transaction—affects interstate commerce" and warning that if dormant Commerce Clause applied to "all laws affecting commerce—that is, to all state and local laws addressing a subject that Congress *could* regulate, if it chose—then judicial review of statutory wisdom after the fashion of

Lochner would be the norm" (emphasis in original)).[19]

A number of our sister circuits have concluded that state escrow and contraband statutes do not regulate commerce extraterritorially in violation of the Commerce Clause. *See S&M Brands, Inc. v. Caldwell*, 614 F.3d 172, 177-78 (5th Cir. 2010); *Grand River Enters. Six Nations, Ltd. v. Beebe*, 574 F.3d at 943-44 [8th Cir.]; *KT&G Corp. v. Attorney Gen. of Okla.*, 535 F.3d at 1143-46 [10th Cir.]; *Star Scientific, Inc. v. Beales*, 278 F.3d 339, 354-57 (4th Cir. 2002). We reach the same conclusion in this case. Plaintiffs having been afforded the opportunity to prove at trial that New York's Escrow and Contraband Statutes did, in fact, impermissibly regulate interstate commerce, and having failed to carry their burden, we affirm

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[19] Commentators have also cautioned that the Commerce Clause's ban on extraterritorial regulation must be applied carefully so as not to invalidate many state laws that have permissible extraterritorial effects *See generally* Gillian E Metzger, *Congress, Article IV, and Interstate Relations*, 120 Harv. L Rev 1468, 1521 (2007) ("[T]he extent of the prohibition on the states themselves should not be overstated In practice, states exert regulatory control over each other all the time . The prohibition on extraterritorial legislation is thus understood only to constrain a state from formally asserting legal authority outside its borders ."), Mark D Rosen, *Extraterritoriality and Political Heterogeneity in American Federalism*, 150 U Pa L Rev. 855, 919-30 (2002) (arguing that ban on extraterritorial regulation applies only to protectionist laws, regulations of non-citizens, and inconsistent regulations), Jack L Goldsmith & Alan O Sykes, *The Internet and the Dormant Commerce Clause*, 110 Yale L J 785, 795 (2001) ("Innumerable state laws affect outsiders, and no one thinks that all (or even most) of these laws violate the dormant Commerce Clause ").

the judgment of the district court in favor of defendants.

III. *Conclusion*

To summarize, we conclude as follows:

1. The record evidence supports the district court's finding that plaintiffs failed to prove that New York's Escrow and Contraband Statutes delegate any regulatory power to private parties. Accordingly, the district court properly concluded that the challenged statutes are not preempted by the Sherman Act.

2. The record evidence further supports the district court's determination that any potentially anti-competitive aspects of the New York Escrow and Contraband Statutes were clearly articulated and affirmatively expressed as state policy as well as actively supervised by the state itself, such that defendants qualified for state action immunity as recognized in *Parker v. Brown*, 317 U.S. 341.

3. Plaintiffs' failure to prove that the challenged statutes have an extraterritorial effect on commerce supports the district court's rejection of their dormant Commerce Clause challenge to the New York Escrow and Contraband Statutes.

AFFIRMED.

B1

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

No. 02 Civ. 2939 (AKH)

January 12, 2009

FREEDOM HOLDINGS, INC., d/b/a North American Trading Company, and International Tobacco Partners, Ltd.,

Plaintiffs,

—v.—

ANDREW M. CUOMO, in his official capacity as Attorney General of the State of New York, and ROBERT L. MEGNA, in his official capacity as Commissioner of Taxation and Finance of the State of New York,

Defendants.

David F. Dobbins, Sr., Patterson, Belknap, Webb & Tyler LLP, New York, NY, Walter Michael Luers, Law Offices of Walter M. Luers, LLC, Atlantic Highlands, NJ, *for Plaintiffs.*

Avi Schick, New York State Department of Law (EPB), Albany, NY, Christine E. Morrison, Eliot Spitzer, Attorney General of the State of NY, Dana Hope Biberman, NYC Law Department, Office of the Corporation Counsel, Lewis Aaron Polishook, New York, NY, Julie Simone Brill, VT Attorney General's Office, Montpelier, VT, Gary D. Wilson, Washington, DC, *for Defendants.*

OPINION AND ORDER GRANTING JUDGMENT DISMISSING COMPLAINT

ALVIN K. HELLERSTEIN, *District Judge*:

In 1998, after many years of frustrating federal, state, and private litigation, the attorneys general of forty-six States entered into a Master Settlement Agreement with the major cigarette companies. The New York Supreme Court, reviewing the settlement, found that it went "well beyond what could have been achieved in plaintiffs' fondest dreams for the result after a protracted and risky trial," and that it "painstakingly accommodates the public interest" by compensating the State for past and future public health expenditures caused by cigarette smoking, while discouraging future cigarette consumption. *New York v. Philip Morris, Inc.*, 179 Misc.2d 435, 686 N.Y.S.2d 564, 569 (N.Y.Sup.Ct.1998), *aff'd,* 263 A.D.2d 400, 693 N.Y.S.2d 36 (1st Dep't 1999).

Ten years have passed since the Master Settlement Agreement became effective. In that time, New York has reaped substantial benefits from it,

consistent with the public purposes that animated the settlement. Most prominently, the State has received nearly $7.7 billion in compensation for health care costs, while the number of cigarettes sold each year in the United States has declined by 24%, from 484.5 cigarettes sold in 1997 to 365.8 billion cigarettes sold in 2007.

This lawsuit began in 2002, almost seven years ago. It has been to the Court of Appeals twice, resulting in three opinions. I expressed my views of the probable merits in largely denying Plaintiffs' motion for a preliminary injunction. Since then, and after remand from the Court of Appeals, the parties presented a full record to me and moved for judgment pursuant to Fed.R.Civ.P. 52. At my request, the parties supplemented the record at a three-day evidentiary hearing. I have now heard all relevant arguments, and issue this decision as a final determination of the issues.

Based on the supplemented record, the three opinions issued in this case by the Court of Appeals, and my own findings and conclusions issued in an opinion and order dated September 14, 2004, I hold as follows:

1. Plaintiffs have failed to show that the Master Settlement Agreement and its implementing legislation restrain the ability of non-participating cigarette manufacturers to compete.

2. Plaintiffs have failed to show that the Master Settlement Agreement and its implementing legislation violate the Commerce Clause of the United States Constitution.

3. Plaintiffs have failed to show that New York's Allocable Share Release amendment restrains competition or violates the Commerce Clause.

4. Plaintiffs have suffered no injury to their business or property, actual or threatened.

5. Plaintiffs are entitled to no legal or equitable relief.

Accordingly, for the reasons discussed in this opinion, I grant judgment to Defendants, dismissing the case against them, and dissolve the preliminary injunction that I previously granted.

I. *The Prior Proceedings*

At the outset of this case, I dismissed the Complaint, ruling that it failed to allege a legally sufficient claim for relief under either the federal antitrust laws or the Commerce Clause of the United States Constitution. Order of May 15, 2002. The Court of Appeals affirmed my ruling as to the Commerce Clause claim, but reversed my ruling as to the antitrust claim and ordered that portion of the Complaint reinstated on remand. 357 F.3d 205 (2d Cir.2004) (*Freedom Holdings I*), *reh'g denied & opinion revised,* 363 F.3d 149 (2d Cir.2004) (*Freedom Holdings II*). After remand and discovery, Plaintiffs moved for a preliminary injunction against enforcement of the Master Settlement Agreement and its implementing legislation in New York. I denied most of the motion, but enjoined the effectiveness of the recent Allocable Share Release amendment to the New York Public Health Law. 447 F.Supp.2d 230 (S.D.N.Y.2004) (*Freedom Holdings III*). The Court of Appeals

affirmed, holding that Plaintiffs had failed to show irreparable injury, except as regards the Allocable Share Release amendment. 408 F.3d 112 (2d Cir.2005).

After the second remand, Plaintiffs moved to amend the Complaint to add a count alleging a Commerce Clause violation. I allowed the amendment because the Court of Appeals had recently reversed the dismissal of a similar Commerce Clause claim in *Grand River Enters. Six Nations, Ltd. v. Pryor*, 425 F.3d 158, 169-73 (2d Cir.2005).

At the close of discovery, both Plaintiffs and Defendants moved for summary judgment pursuant to Fed.R.Civ.P. 56 or judgment pursuant to Fed.R.Civ.P. 52. I agreed to decide the case as if after a bench trial pursuant to Rule 52. After arguments, presentation of evidence, and submissions of updated economic data, I now deliver my findings and conclusions on a complete record.

In addition, I have reviewed, de novo, the extensive factual record before me in *Freedom Holdings III*, as reintroduced and supplemented to support the present motions. Except as specifically indicated below, I adhere to and incorporate here the findings and conclusions of *Freedom Holdings III*.

II. *Summary of the MSA*

In *Freedom Holdings III*, I presented an extensive summary of the MSA, its interconnecting provisions, and its purposes and applications. 447 F.Supp.2d at 233-42. As the parties have pointed out no error, I need not repeat that analysis in fresh detail. I incorporate it by reference, as the basis of this decision as well, and offer an abridged description here.

The Master Settlement Agreement ("MSA") resolved massive litigation brought by the Attorneys General of forty-six states (including New York), the District of Columbia, and several territories, against the four largest cigarette manufacturing and marketing companies, Philip Morris, Inc., R.J. Reynolds Tobacco Co., Brown & Williamson Tobacco Co., and Lorillard Tobacco Co.[1] The States alleged that cigarette smoking had caused them to incur billions of dollars in Medicaid and other public health costs, and sought recovery of those costs and injunctive relief to reduce future damage. They reached an agreement with the companies and entered into the MSA on November 23, 1998. The MSA required the four major cigarette companies, designated "Original Participating Manufacturers," or OPMs, to make substantial payments to the States pursuant to several formulas, immediately and over time. Collectively, they were to pay about $2.4 billion in the first year and about $225 billion over the next twenty-five years. In exchange, the States surrendered past, present, and future tobacco-related claims against the OPMs. The MSA contemplated that the OPMs would meet their payment obligations by increasing the prices of their cigarettes, thereby reducing future public cigarette consumption. The amount owed by each OPM would be adjusted annually to account for inflation and changes in the OPMs' relative mar-

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[1] Philip Morris is now a wholly-owned subsidiary of Altria Group, Inc. Brown & Williamson and R.J. Reynolds have since merged, forming a new parent, Reynolds American, Inc.

ket shares. *See Freedom Holdings III*, 447 F.Supp.2d at 234-35.

In approving the settlement, the New York Supreme Court found that the MSA achieved New York's most important goals when it first filed suit. *New York v. Philip Morris*, 686 N.Y.S.2d at 568. Most plainly, the MSA compensated New York for past public health expenditures while promising a revenue stream to pay for future care. In addition, by charging more for cigarettes, the OPMs promoted the public health by discouraging present smokers from continuing and potential smokers from beginning. The MSA's other provisions also advanced the same public health goal by banning advertising and sales of cigarettes to minors, requiring greater disclosure of the health effects of tobacco and nicotine, and requiring the OPMs to fund educational and clinical programs that publicize and treat the health consequences of smoking.[2] The MSA "goes well beyond what could have been achieved in plaintiffs' fondest dreams for the result after a protracted and risky trial," the New York Supreme Court concluded, "and . . . painstakingly accommodates the public interest." *Id.* at 569; *see* N.Y. Pub. Health Law § 1399-nn(5).

The MSA encouraged other cigarette companies to participate in the settlement as "Subsequent Participating Manufacturers," or SPMs. It pro-

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[2] Indeed, the New York Supreme Court noted that litigation, or even legislation, could not have achieved some aspects of the MSA, like the OPMs' waiver of their First Amendment advertising and lobbying rights. *New York v Philip Morris*, 686 N.Y.S.2d at 568 & 569 n. 6, *see Freedom Holdings III*, 447 F.Supp.2d at 250.

vided a "grandfathered" benefit to companies that joined the MSA within sixty days of November 23, 1998, its execution date. These grandfathered SPMs incur payment obligations only if their share of the total cigarette market exceeds the greater of their 1998 share or 125% of their 1997 share. Those payment obligations, like those of SPMs that joined the MSA after the sixty day period, are determined according to an arithmetical formula that results in payments similar to those required of OPMs.[3] Together, the OPMs and SPMs are designated "Participating Manufacturers," or PMs.

The States and the OPMs anticipated that the design of the MSA was vulnerable to the actions of companies that chose not to join it, designated "Non-Participating Manufacturers," or NPMs. If NPMs could sell cigarettes at prices that did not reflect the settlement burden assumed by PMs,

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[3] The annual payment obligations of grandfathered SPMs and non-grandfathered SPMs are calculated differently. *See* MSA Art. IX(i). If a grandfathered SPM's sales increase, it pays a portion of the total SPM adjusted base payment (which is a volume-adjusted version of the total OPM base payment). This portion is determined by dividing the increase in the grandfathered SPM's market share by the current aggregate market share of OPMs. Thus

$$\frac{\text{(current market share)-(greater of 1998 market share or 125\% of 1997 market share)}}{\text{current aggregate market share of OPMs}}$$

A non-grandfathered SPM also pays a portion of the total SPM adjusted base payment, but regardless of whether its market share increased, remained flat, or decreased. This portion is determined by dividing its actual market share (not just the increase) by the current aggregate market share of OPMs. *See* MSA Art. IX(i)(4).

the entire structure of the MSA would be defeated, and the fundamental goal of reducing cigarette consumption would be frustrated. To solve this problem, the MSA provided for States to adopt legislation known as "Escrow Statutes," which require NPMs to make payments into state-specific escrow accounts that are somewhat less than, but roughly equivalent to, the payments required by PMs. These payments prevent NPMs from taking advantage of the MSA by significantly undercutting PMs on price, and assure the States that funds will be available to pay damages if the States prevail in lawsuits against NPMs. *See* N.Y. Pub. Health Law § 1399-nn(6) ("It is thus in the interest of the state to require that [NPMs] establish a reserve fund to guarantee a source of compensation and to prevent such manufacturers from deriving large, short-term profits and then becoming judgment-proof before liability may arise."). Thus, the Escrow Statutes preserve the MSA and the public health benefits that it sought to foster.

If a State fails to enact or "diligently enforce" an Escrow Statute, it exposes itself to the MSA's "NPM Adjustment" provision, which can reduce OPMs' MSA payments. MSA Art. IX(d). If the OPMs prove that they collectively lost market share to the NPMs, that the MSA was a "significant factor" in that loss, and that the State in issue failed to enact or diligently enforce an Escrow Statute, the OPMs can reduce their payments by three times the amount of market share loss over 2%. MSA Art. IX(d)(1). To date, no NPM adjustment has been granted, although The Brattle Group, the firm tasked with making the "significant factor" determination, concluded in 2003,

2004, and 2005 that the MSA had been a "significant factor" in the OPMs' loss of market share. *See* Pl. Exh. 362, ¶ 228. The Brattle Group's determination, however, must be paired with an arbitrator's finding that a State failed to "diligently enforce" its Escrow Statute, which has yet to occur.

In 2001, to aid enforcement of its Escrow Statute, New York passed its Contraband Statute. N.Y. Tax Law §§ 480-b, 481(1)(c), 1846. The Contraband Statute requires every cigarette manufacturer selling cigarettes in New York to certify annually that it is either making payments under the MSA as a PM or complying with the Escrow Statute as an NPM. A manufacturer that fails to certify under the Contraband Statute is denied state tax stamps, which allow a manufacturer to sell cigarettes without incurring regulatory and monetary penalties.

The PMs deposit their annual payments into a national escrow account, from which each State receives its "allocable share." This share, fixed in the MSA, generally represents the State's proportional burden of past and future damages. *Freedom Holdings III*, 447 F.Supp.2d at 236; *see* MSA Exh. A. Initially, Escrow Statutes provided that NPMs could claim a refund of their annual escrow payment to the extent that the amount they paid exceeded the State's allocable share of total national payments. This Allocable Share Release provision allowed NPMs to reduce their overall obligations by concentrating their sales within a single State or a few States, thereby becoming entitled to refunds from the States and lowering their marginal escrow payments signif-

icantly below the costs incurred by OPMs. For example, if an NPM sold cigarettes only in New York, which has an allocable share of 12.76%, it could receive a credit for all per-cigarette payments under New York's Escrow Statute that exceed 12.76% of its total sales, despite selling 100% of its cigarettes in the State.

The States, including New York, began to repeal the Allocable Share Release provisions of their Escrow Statutes, thereby eliminating the yearly refunds. In *Freedom Holdings III,* I enjoined New York from repealing its Allocable Share Release provision. *See* N.Y. Pub. Health Law § 1399-pp, as amended, 2003 N.Y. Laws 666, eff. Oct. 15, 2003. I was concerned, given the paucity of market data, that the repeal could "jeopardize the ability of the NPMs to compete with the SPMs and OPMs," and I considered that more experience was needed. 447 F.Supp.2d at 246. Since then, every MSA State but one has likewise amended its Escrow Statute to preclude any yearly recovery of escrowed funds, to prevent market leveraging by regional NPMs at the expense of PMs.

III. *Developments Since Freedom Holdings III*

In this section, I present new developments and updated data from the four years since my decision in *Freedom Holdings III.* PricewaterhouseCoopers, the independent auditor appointed under the MSA, charts the annual tax costs of cigarettes from reports of federal excise taxes paid by manufacturers and sellers of cigarettes, as well as U.S. Customs data. *Freedom Holdings III* presented the relevant data, comparative statistics among OPMs, SPMs, and NPMs, which the parties

have extended through 2007. *See* 447 F.Supp.2d at 238.

The updated reports reveal that the payment structure of the MSA does not favor the major cigarette companies over those companies that either did not join the MSA, or joined the MSA at some later date. *See* Table 1. The OPMs continue to pay more per carton ($5.31 in 2007), including payments to the four previously settled states, than do the non-grandfathered SPMs ($5.07), and both pay more than NPMs pay under the Escrow Statutes ($5.02). Grandfathered SPMs, viewed in isolation, have the lowest average payment obligation ($2.63), since they pay nothing for cigarettes sold up to their grandfathered threshold (the greater of their 1998 market share or 125% of their 1997 market share). However, for sales beyond this threshold, grandfathered SPMs pay about what non-grandfathered SPMs pay ($5.07), which is more than NPMs pay. Tr. 257-58, 276-77;[4] *see* Def. Exh. E, tbl. 3; Def. Exh. H, tbl. 3.

The reports also reveal that the MSA, as intended by the States, has produced a secular decrease in cigarette consumption. *See* Table 2. Both the total volume of annual cigarette sales and the volume of cigarettes sold annually by the OPMs have decreased steadily since the MSA's inception. The total number of cigarettes sold fell from 484.5 billion cigarettes in 1997 to 365.8 billion cigarettes in 2007, a decline of about 24%. Def. Exh. E, tbl. 1.

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[4] "Tr." refers to the transcript of the evidentiary hearing held on November 18-20, 2008

Finally, the reports reveal that the competitive dominance of the major cigarette companies has slipped significantly over the life of the MSA. *See* Table 2. In 1997, the OPMs controlled 97.1% of the market, but their share fell to 85.9% in 2002 and has remained steady since then. Sales by SPMs represented 8.8% of the market in 2007, a drastic increase from their 2.5% share of the market in 1997. NPMs' share of the market rose from 0.4% in 1997 to a peak of 8.1% in 2003, but declined somewhat to 5.4% in 2007.[5]

In 2007, New York was due about $905 million under the MSA. From all PMs, from 1999 through 2008, New York has received nearly $7.7 billion under the MSA. Tr. 261-65; *see* Def. Exh. F, tbl. 6.

In sum, the updated data offer no evidence that the MSA has either favored the OPMs or prejudiced the NPMs competitively. SPMs and NPMs continue to compete vigorously with OPMs for market share. Together, they have accumulated market share at the expense of the OPMs, which controlled 97.1% of the market in 1997, but only 85.9% in 2007. NPMs controlled 0.4% of the cigarette market in 1997 and now control 5.4% of the market. Moreover, these market statistics understate NPM sales because many NPMs sell cigarettes through the Internet or Indian reservations to avoid federal excise tax collection, and such sales exist outside PricewaterhouseCoopers's data. Tr. 239-40, 317-18, 364-65.

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[5] General Tobacco, the largest NPM to become a non-grandfathered SPM, joined the MSA in July 2004, which accounts for the fact that the SPMs' total market share has expanded slightly at the NPMs' expense in the years since. Tr. 268-76, 314-15, Def Exh W, tbl 1b

Table 1

Average OPM, SPM, and NPM Payments per 200-Cigarette Carton (to nearest cent)[6]

YEAR	OPMs	Grandfathered SPMs[7]	Non-Grandfathered SPMs	NPMs
1999	$3.91	$0.48	$2.02	$1.94
2000	$4.39	$0.81	$2.39	$2.23
2001	$5.20	$1.31	$3.18	$2.99
2002	$5.05	$1.65	$3.34	$3.08
2003	$4.21	$1.87	$4.02	$3.90
2004	$4.28	$1.81	$4.07	$4.03
2005	$4.49	$2.12	$4.27	$4.16
2006	$4.59	$2.33	$4.35	$4.29
2007	$5.31	$2.63[8]	$5.07	$5.02

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[6] Def Exh. E, tbl. 3

[7] This column represents the average payment for all cigarettes sold by grandfathered SPMs—that is, sales both below and above the grandfathered threshold.

[8] For cartons sold above the SPMs' grandfathered thresholds, the marginal per-carton payment was $5.07 in 2007, matching the average per-carton payment of non-grandfathered SPMs. *See* Def. Exh. H, tbl. 3

Table 2

OPM, SPM, and NPM Market Share (to nearest 0.1%) and Total Market Size (in billions of cigarettes, to nearest 100 million)[9]

	Grandfathered		Non-Grandfathered		Total Market
Year	OPMs	SPMs[10]	SPMs	NPMs[11]	Size
1997	97.1%	2.5%	0.0%	0.4%	484.5
1998	96.5%	3.0%	0.0%	0.5%	459.3
1999	93.9%	4.4%	<0.1%	1.6%	439.1
2000	91.5%	5.3%	<0.1%	3.2%	432.9
2001	89.4%	6.2%	0.1%	4.3%	426.3
2002	85.9%	7.2%	0.1%	6.7%	414.3
2003	84.5%	6.8%	0.7%	8.1%	399.9
2004	84.8%	6.5%	1.3%	7.3%	400.3
2005	85.3%	7.2%	1.8%	5.7%	384.3
2006	84.8%	7.8%	2.0%	5.3%	384.7
2007	85.9%	7.6%	1.2%	5.4%	365.8

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[9] Def Exh W, tbl 1 a, Def. Exh. E, tbl 1

[10] For 1997, 1998, and 1999, the figures for grandfathered SPMs include all such companies, regardless of when they joined the MSA

[11] Theodore Martens of PricewaterhouseCoopers testified that his firm derives the data in this column by subtracting OPM and SPM volume totals from the total market volume as determined from federal excise tax data, since PricewaterhouseCoopers is not authorized to access tax data for NPMs Tr. 270-71.

IV. *Discussion*

A. *Standard for Judgment*

Both sides move on the complete record for judgment pursuant to Rules 52 and 56 of the Federal Rules of Civil Procedure, asking me to resolve such factual issues as I may find, treating the record as equivalent to that produced by a bench trial. Because both sides represent that they have presented all relevant evidence, because no questions of credibility require live testimony, and because expert witnesses testified at my request to clarify ambiguous points, I gave my consent. Therefore, this opinion presents my findings of fact and conclusions of law as if after a full trial.

B. *Standing*

To establish standing to sue under Article III of the United States Constitution, a plaintiff must show "that it has suffered a concrete and particularized injury that is either actual or imminent, that the injury is fairly traceable to the defendant, and that it is likely that a favorable decision will redress that injury." *Massachusetts v. EPA*, 549 U.S. 497, 127 S.Ct. 1438, 1453, 167 L.Ed.2d 248 (2007) (citing *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560-61, 112 S.Ct. 2130, 119 L.Ed.2d 351 (1992)). The "gist of the question of standing" is whether the plaintiffs have a sufficient stake in the outcome of the controversy to assure genuine adverseness and clear presentation of the issues at stake. *Id.*; *see also Baker v. Carr*, 369 U.S. 186, 204, 82 S.Ct. 691, 7 L.Ed.2d 663 (1962). In a lawsuit challenging the legality of government action, it is typically easier for a direct object of the chal-

lenged action to establish standing than it is for one alleging the "unlawful regulation . . . of *someone else.*" *Lujan,* 504 U.S. at 561-62, 112 S.Ct. 2130. However, such a plaintiff may nonetheless establish standing by demonstrating that the response of third parties to the challenged regulation threatens or causes an injury to the plaintiff, and that judgment for the plaintiff will redress the injury caused by third parties responding to the regulation. *Id.*; *see Allen v. Wright,* 468 U.S. 737, 757-66, 104 S.Ct. 3315, 82 L.Ed.2d 556 (1984).

In addition to establishing Article III standing, a plaintiff seeking an injunction pursuant to § 16 of the Clayton Act, 15 U.S.C. § 26, must "allege threatened loss or damage 'of the type the antitrust laws were designed to prevent and that flows from that which makes defendants' acts unlawful.'" *Cargill, Inc. v. Monfort of Colo., Inc.,* 479 U.S. 104, 109-13, 107 S.Ct. 484, 93 L.Ed.2d 427 (1986) (quoting *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.,* 429 U.S. 477, 489, 97 S.Ct. 690, 50 L.Ed.2d 701 (1977)). The antitrust standing analysis is more flexible and less demanding for claims for injunctive relief than it is for those seeking money damages, because "one injunction is as effective as 100, and . . . 100 injunctions are no more effective than one." *Id.* at 111 n. 6, 107 S.Ct. 484 (quoting *Hawaii v. Standard Oil Co.,* 405 U.S. 251, 261, 92 S.Ct. 885, 31 L.Ed.2d 184 (1972)); *see also Daniel v. Am. Bd. of Emergency Med.,* 428 F.3d 408, 443-44 (2d Cir.2005); *Consol. Gold Fields PLC v. Minorco, S.A.,* 871 F.2d 252, 257-60 (2d Cir.1989).

Plaintiff Freedom Holdings, Inc. ("Freedom Holdings") imports cigarettes manufactured abroad for resale to a Native American distributor in Salamanca, New York that does not affix tax stamps pursuant to New York's Contraband Statute. Accordingly, Freedom Holdings has never sold cigarettes tax-stamped pursuant to that law or made escrow payments pursuant to New York's Escrow Statute. *See* N.Y. Tax Law §§ 480-b, 481(1)(c), 1846; N.Y. Pub. Health Law § 1399-nn-pp. Freedom Holdings claims that it wants to market and sell its Image brand cigarettes through other distributors in New York, and that it will do so if it prevails in this case.

Plaintiff International Tobacco Partners, Ltd. ("ITP") imports Cobra brand cigarettes from International Masis Tabac, an Armenian manufacturer, for resale to direct buying wholesalers in New York. ITP has opened an escrow account in New York on behalf of International Masis Tabac, and deposits the statutory escrow payments into that account. International Masis Tabac has declared that ITP bears responsibility for such payments, and thus is entitled to any funds released pursuant to New York's Allocable Share Release provision, although ITP sells only a fraction of its total sales volume in New York and has not sought any release of funds.

Plaintiffs seek a declaratory judgment that the MSA and its implementing legislation, the Escrow and Contraband Statutes, violate the Commerce Clause of the U.S. Constitution, § 1 of the Sherman Act, and § 16 of the Clayton Act. U.S. Const. art. I, § 8; 15 U.S.C. §§ 1, 26. Plaintiffs also seek a permanent injunction against enforcement of New

York's Escrow and Contraband Statutes, along with fees and costs. *See* N.Y. Pub. Health Law § 1399-nn-pp; N.Y. Tax Law §§ 480-b, 481(1)(c), 1846. Plaintiffs do not seek money damages. Second Suppl. & Am. Compl. ¶¶ 93-102 & Prayer for Relief.

The MSA and Escrow and Contraband Statutes impose obligations on manufacturers and licensed, tax-stamping wholesalers, but they do not directly obligate Plaintiffs, who are distributors and importers. *See* N.Y. Pub. Health Law §§ 1399-nn-pp; N.Y. Tax Law §§ 480-b, 481(1)(c), 1846. Defendants argue that Plaintiffs therefore lack Article III standing to assert their claims. However, Plaintiffs' inability to sell cigarettes without making statutory escrow payments, directly or indirectly, satisfies the constitutional requirement of an injury in fact. This injury is redressible because an injunction against operation of the challenged statutes would allow Plaintiffs to sell cigarettes without making the allegedly anticompetitive and illegal escrow payments. *See, e.g.*, *Lujan*, 504 U.S. at 561-62, 112 S.Ct. 2130. The causal connection between the challenged state action and Plaintiffs' injury is sufficiently direct and non-speculative. Therefore, Plaintiffs have satisfied their burden to demonstrate standing under Article III.

Plaintiffs also have standing to sue for an injunction pursuant to § 16 of the Clayton Act. 15 U.S.C. § 26. If Plaintiffs were seeking damages under § 4 of the Clayton Act, arguing that the MSA creates an anticompetitive cartel that reduces output to charge higher prices, they would lack antitrust standing. Though such conduct

would violate the law, Plaintiffs would benefit, not suffer, from both higher market prices and the chance to undersell members of the cartel to capture new market share. *See Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 583, 106 S.Ct. 1348, 89 L.Ed.2d 538 (1986). However, Plaintiffs seek injunctive relief, for which the standing inquiry is more flexible, reflecting greater concern for the public interest and reduced risk of duplicative recovery. *See Minorco*, 871 F.2d at 260 n. 6. Plaintiffs allege that New York passed the Escrow and Contraband Statutes to further its agreement with the four major manufacturers to punish NPMs for competing with members of the MSA cartel. Because allegations of "[l]osses inflicted by a cartel in retaliation for an attempt ... to compete" constitute a valid antitrust claim, Plaintiffs have established standing to sue under the Sherman and Clayton Acts. *Hammes v. AAMCO Transmissions, Inc.*, 33 F.3d 774, 783 (7th Cir.1994); *see also Volvo N. Am. Corp. v. Men's Int'l Prof'l Tennis Council*, 857 F.2d 55, 67-68 (2d Cir.1988).

C. *Sherman Act Preemption*

In *Freedom Holdings I*, the Court of Appeals held that Plaintiffs had stated a legally sufficient claim for relief that the Sherman Act, 15 U.S.C. § 1, preempts New York's Escrow and Contraband Statutes. It explained that a "two-step analysis" determines whether a state statute is preempted: First, a plaintiff must show that the statute creates a scheme that would be a "per se violation" of the Sherman Act if arranged privately, and second, a plaintiff must show that the state action

doctrine of *Parker v. Brown*, 317 U.S. 341, 63 S.Ct. 307, 87 L.Ed. 315 (1943), does not immunize the statute from preemption. *Freedom Holdings I*, 357 F.3d at 222-23. Accepting the allegations of the Complaint as proved, the Court of Appeals held that the MSA reflects an agreement among private parties, aided and abetted by the States, to create a scheme for market control, that the scheme "mandates or authorizes conduct" or "places irresistible pressure" on parties to violate the antitrust laws, and that such conduct "in all cases" constitutes a "per se violation" of the Sherman Act.[12] It further held that *Parker* immunity was unavailable because New York had neither "clearly articulated" the "legitimate state policy goals" behind the MSA nor "actively supervised" the mechanisms that advance those goals to minimize "unnecessary anticompetitive effects." *Id.*; *see Cal. Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. 97, 105, 100 S.Ct. 937, 63 L.Ed.2d 233 (1980). Accordingly, the Court of Appeals concluded that Plaintiffs had stated a legally sufficient claim for relief that the Sherman Act preempts the Escrow and Contraband Statutes.

I hold, based on my findings of fact and conclusions of law in *Freedom Holdings III*, and informed by renewed consideration of my legal

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[12] Accepting as proved the Complaint's allegation that the challenged statutes grant regulatory power to private actors, the Court of Appeals ruled that the Escrow and Contraband Statutes were not merely unilateral acts of state government, but "hybrid restraint[s]" vulnerable to preemption by the federal antitrust laws *Id.* at 223, *see 324 Liquor Corp v. Duffy*, 479 U.S 335, 345-46 n. 8, 107 S Ct 720, 93 L.Ed.2d 667 (1987)

analysis and updated data presented by the parties at an evidentiary hearing to clarify ambiguities, that Plaintiffs have failed to prove that the MSA and its implementing legislation in New York constitute a per se violation of the Sherman Act. I also hold that the *Parker* state action doctrine immunizes the Escrow and Contraband Statutes from Sherman Act preemption.

1. *Per Se Violation*

In *Freedom Holdings III*, I noted that the caselaw has developed two different understandings of what constitutes a per se violation of the antitrust laws. 447 F.Supp.2d at 248-52. The first understanding examines the restraint and its effects in the context of any redeeming social benefits, while the second looks only to the abstract character of the restraint. I concluded that Plaintiffs had not shown a likelihood of success on their antitrust preemption claim under either understanding. At a minimum, Plaintiffs must show that the MSA and its implementing legislation frustrate competition in the cigarette market. The Supreme Court has held that, to establish a per se antitrust violation arising from a state statute, a plaintiff must show that the statute "mandates or authorizes conduct that necessarily constitutes a violation of the antitrust laws in all cases, or . . . places irresistible pressure on a private party to violate the antitrust laws in order to comply with the statute." *Rice v. Norman Williams Co.*, 458 U.S. 654, 661, 102 S.Ct. 3294, 73 L.Ed.2d 1042 (1982); *see 324 Liquor Corp. v. Duffy*, 479 U.S. 335, 345 n. 8, 107 S.Ct. 720, 93 L.Ed.2d 667 (1987) ("[F]ederal antitrust laws pre-empt state laws

authorizing or compelling private parties to engage in anticompetitive behavior."). Only authorized or compelled practices that have a "pernicious effect on competition and lack . . . any redeeming virtue" are deemed per se antitrust violations. *Rice,* 458 U.S. at 659 n. 5, 102 S.Ct. 3294.

In their Second Supplemental and Amended Complaint, Plaintiffs allege that the MSA creates, and the Escrow and Contraband Statutes enforce, an illegal output cartel engaged in market division and price-fixing. They argue that the MSA discourages the OPMs comprising the cartel from gaining market share relative to each other by increasing their payment obligations if they do so. Allegedly, the MSA thereby encourages OPMs to raise prices beyond the level necessary to accommodate their payment burdens, because they know that the other OPMs will follow their price increases rather than gain market share. Thus, Plaintiffs conclude that the OPMs can amass a fund for advertising and marketing that overwhelms the NPMs' ability to compete. The States, Plaintiffs allege, sponsor this scheme and protect the OPMs' market dominance because they reap enormous sums from annual payments under the MSA. Accordingly, Plaintiffs claim that the Escrow and Contraband Statutes bind the NPMs into a market in which they cannot compete.[13]

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[13] The Court of Appeals summarized Plaintiffs' allegations: "[T]he combination of the MSA, the Escrow Statutes, and the Contraband Statutes, allows OPMs to set supracompetitive prices that effectively cause other manufacturers either to charge similar prices or to cease selling. . NPMs are forced to charge these prices to cover the costs imposed by the Escrow and Contraband Statutes or go out of business in New York." *Freedom Holdings I,* 357 F 3d at 226

Accepting the allegations as proved, the Court of Appeals found that Plaintiffs had "sufficiently alleged a per se violation of the Sherman Act" because the MSA, as described in the Complaint, is a "naked restraint on competition, albeit one subject to erosion by NPMs." *Freedom Holdings I,* 357 F.3d at 226.

The proofs do not sustain Plaintiffs' allegations. The MSA and the Escrow and Contraband Statutes neither inhibit competition nor lack redeeming virtue. *See Rice,* 458 U.S. at 659 n. 5, 102 S.Ct. 3294. The proofs reveal that the NPMs have retained pricing autonomy and gained substantial market share at the expense of the OPMs, and that ample evidence of the MSA's redeeming public health virtues belies any anticompetitive design.

The proofs do not show a "pernicious effect on competition" caused by the MSA and the Escrow and Contraband Statutes. *See id.* To the contrary, they show plainly that NPMs like Plaintiffs have not suffered any competitive injury as a result of the MSA. Since 1999, the NPMs have competed vigorously to increase their share of the domestic cigarette market from 0.4% in 1997 to 5.4% in 2007. Over the same term, the market share of the OPMs has declined from 97.1% to 85.9%. These trends have occurred in a market whose total volume has contracted from 484.5 billion to 365.8 billion cigarettes sold annually, a contraction in sales and consumption that has advanced the public health aims of the States considerably.[14] In

[14] Plaintiffs also contend that the decline in cigarette consumption began before the MSA, but no one can say that

Freedom Holdings I, the Court of Appeals considered that, by measuring PMs' payment obligations by their relative market shares, the MSA discourages growth and natural competition. The data, however, reveal that neither NPMs nor SPMs have acted as if discouraged.

The fact that NPMs have not suffered competitively, but rather prospered, over the life of the MSA is unsurprising because nothing in the MSA or its implementing legislation hinders NPMs in relation to PMs. The payment structure compelled by the MSA and the Escrow Statutes has not disadvantaged NPMs. Indeed, the proofs show that NPMs have actually paid less per carton ($5.02 in 2007) than have their competitors ($5.31 for OPMs, $2.63 with a marginal rate of $5.06 for grandfathered SPMs, and $5.07 for non-grandfathered SPMs). *See* N.Y. Pub. Health Law § 1399-pp(2) (fixing flat rate of $0.0188482 per cigarette). These figures undermine the argument that "NPMs are deterred from seeking increased market share because the high costs of compliance with the Escrow Statute preclude their competing through lower prices." *Freedom Holdings II*, 363 F.3d at 152; *see KT & G Corp. v. Att'y Gen. of Okla.*, 535 F.3d 1114, 1133 (10th Cir.2008) ("In light of the fact that [OPMs, SPMs, and NPMs] all face roughly the same per-cigarette cost under either the MSA or the allocable share amendment, there is no indication that they will avoid increasing their own market share, nor is there any suggestion that they will not unilaterally make their own pricing and output decisions."). Nonetheless,

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the MSA did not provide a major impetus to cause the decline to continue and accelerate

Plaintiffs argue that the MSA disfavors NPMs because OPMs and SPMs may deduct their MSA payments from their income taxes, but NPMs may not similarly deduct their payments to state escrow funds. Those PMs, however, may not recover their payments once made, while NPMs receive annual interest earnings on escrowed funds and will recover, after twenty-five years, any funds not applied to judgments or settlements with the States. Alternatively, NPMs may become eligible to deduct their payments by disclaiming their rights to interest income and reversion of principal. *Freedom Holdings III,* 447 F.Supp.2d at 259; *see Int'l Tobacco Partners, Ltd. v. Kline,* 475 F.Supp.2d 1078, 1083 n. 8 (D.Kan.2007). Thus, I found in *Freedom Holdings III* that nothing in the MSA or the Escrow and Contraband Statutes imposes a relative tax hardship on NPMs. Plaintiffs have offered no evidence to cause me to change my mind.

Many NPMs have joined the MSA, even as non-grandfathered SPMs. But Plaintiffs have presented no reason to infer from this trend that the MSA particularly burdens NPMs. No evident economic force drives NPMs to the MSA. NPMs that become SPMs pay no less to the States than what they paid under the Escrow and Contraband Statutes, and by joining the MSA they subject themselves to upward payment adjustments tied to any gain in market share. It is true that grandfathered SPMs pay the least per carton of all manufacturers, but, as I explained in *Freedom Holdings III,* they pay more than NPMs pay for each successive cigarette they produce, and it is that marginal cost, not the average cost, that

drives manufacturers' pricing decisions. *See* 447 F.Supp.2d at 257-58. In his testimony, Professor Jonathan Gruber explained the basic microeconomics principle of marginal cost pricing to maximize a firm's profits, and stated that, in the competitive cigarette industry, a manufacturer will price its products at or above its marginal cost, not its average cost, for each unit produced. Tr. 325-31. Gruber further testified that there is no reason why a cigarette manufacturer, whether OPM or grandfathered SPM, would price its product below its marginal cost of production, even if that manufacturer is a member of a cartel. Tr. 337-38. The "increased marginal costs to the SPMs above the grandfathered levels can be viewed as a means of recouping those funds which were lost to the states through the grandfather provision." *Freedom Holdings III*, 447 F.Supp.2d at 258. Thus, whatever benefit an SPM such as Liggett Group or Commonwealth Brands enjoys due to the grandfathering provision is not reflected in its pricing decisions, and so has no bearing on marketplace competition. Grandfathered SPMs make the same per-carton payment on marginal sales above their grandfathered thresholds as non-grandfathered SPMs make on every carton they sell, and that payment exceeds the escrow payment required of NPMs.[15] The MSA attracts NPMs

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[15] The Court of Appeals credited Plaintiffs' argument that the MSA's SPM payment formula penalizes SPMs that gain market share from OPMs, which allegedly compels SPMs to follow OPM price increases to avoid gaining market share at their expense *Freedom Holdings II*, 363 F 3d at 153. It is true that the denominator of the ratio used in the formula causes the collective market position of the OPMs to

by offering certainty, not shelter from market forces, as SPMs gain immunity from potentially devastating future litigation with the States. By contrast, NPMs have chosen to accept uncertainty and the benefit of lower payment obligations under the Escrow and Contraband Statutes, including the potential recovery of some or all of their escrow payments.

The MSA has not caused Plaintiffs or other NPMs to surrender pricing autonomy. Through the testimony of Christopher Nelson, Chief Financial Officer of Freedom Holdings, and Jeffrey Avo Uvezian, President of ITP, Plaintiffs concede that their pricing decisions are made independently and that they are not compelled to follow price leadership by their larger competitors. Tr. 109-10; Nelson Dep. 180-81. Likewise, Kevin Altman, who set prices for two NPMs, CigTec and JJA Distributors LLC, testified that both companies made independent pricing decisions that were not dictated by OPMs or SPMs. Tr. 87-88. The aggregate historical data of SPM and NPM market shares, reproduced above, support this testimony. Under the MSA and the Escrow and Contraband Statutes, the OPMs exercise no power, direct or

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affect what an individual SPM must pay, and that, as a result, if an SPM's share of the total market increases, the increase in the amount that it must pay is not directly proportional to its increase in market share, especially if the aggregate total market share of OPMs decreases in the same year *See Freedom Holdings III*, 447 F Supp 2d at 235-36 However, the proofs show that SPMs target the "deep discount" market, and so would be unlikely to follow OPM price increases *See* Tr 94. Moreover, even if SPMs did follow OPM price increases, doing so would create a market opportunity for NPMs, not a competitive disadvantage.

indirect, over the cigarette prices charged by NPMs. Indeed, independent NPMs have taken competitive advantage of higher prices charged by the large cigarette manufacturers. Only the Escrow Statutes impact NPMs' cost structure. *See KT & G Corp.*, 535 F.3d at 1129, 1133; *Sanders v. Brown*, 504 F.3d 903, 911 (9th Cir.2007) ("Nothing . . . forces the NPMs to either peg their prices to those of participating manufacturers, or to refrain altogether from entering the market.") In essence, Plaintiffs allege that New York violates the antitrust laws by compelling NPMs to make payments to escrow funds that they would prefer not to make. This unhappiness, however, does not amount to an antitrust injury. Plaintiffs' grievance parallels that of any manufacturer against a flat tax, which entails the same compulsion, and New York has unquestioned authority to impose such a tax on all cigarette manufacturers. *Freedom Holdings I*, 357 F.3d at 229; *see Freedom Holdings II*, 363 F.3d at 152.

Further, Plaintiffs offer no evidence to support their theory that the MSA has stifled the OPMs' motivation to compete with each other on price. As Plaintiffs recognize, the OPMs, by raising prices beyond the level dictated by their MSA payments, expose themselves, even on their premium product lines, to market erosion by NPMs that sell nearer to their marginal cost, after accounting for escrow payment obligations. Second Suppl. & Am. Compl. ¶¶ 25-26. The parties disagree on the extent of price elasticity and brand salience in the cigarette market, but the data show, and Plaintiffs concede, that cigarette consumers respond to differences in price. As Plaintiffs assert, "the differential in

wholesale prices between the fourth-tier cigarettes sold by NPMs . . . and the premium brands is now $17/carton." *Id.* ¶ 46 n. 4. NPMs may wield fewer resources for marketing and advertising than PMs and lack the economies of scale of the larger PMs. But NPMs can exploit any disproportionate price increase by PMs by selling cigarettes at lower prices, and have done so vigorously to the NPMs' market advantage. *See* Tr. 96, 125; *see also Sanders,* 504 F.3d at 911 ("If the OPMs really are charging artificially high prices, and thus making artificially high profits, an NPM conceivably could compete on price by charging a 'normal' price and still make a 'normal' profit, even taking the escrow payment into account."). Thus, "apportionment [of market share] among OPMs is an internal matter which does not affect the ability of NPMs to compete in any material way." *Freedom Holdings III,* 447 F.Supp.2d at 257.

I found in *Freedom Holdings III,* and I find again, that the States did not intend to create a scheme for market control in favor of the four major cigarette companies that became the OPMs, or in favor of any other cigarette companies. Plaintiffs have presented no proof of such a purpose. The MSA contemplated that PMs would increase their prices, but such increases are consistent with the redeeming social purpose of deterring consumption and sales of cigarettes. The Escrow and Contraband Statutes, and, more recently, the Allocable Share Release amendments, have forced NPMs also to raise their prices for the same redeeming social purpose, to prevent the MSA from being destroyed, and to assure that future lawsuits by the States against the NPMs

will not be frustrated by those companies' financial irresponsibility.

As I found in *Freedom Holdings III*, the States intended that their settlement with the four major tobacco companies have important social benefits, namely, reduction of tobacco consumption, restriction of tobacco advertising and marketing, and transfer of cigarette-induced health care costs from the States to the tobacco companies themselves. The New York Supreme Court, in approving the settlement between New York and the OPMs, found that the MSA achieved the State's critical objectives, more fully than if the lawsuit had gone to judgment. *New York v. Philip Morris*, 686 N.Y.S.2d at 568-69. The Court articulated these objectives in its findings: an injunction against cigarette sales to minors and advertisements targeting minors, greater disclosure of the health effects of tobacco and nicotine, and funding of educational and clinical programs that publicize and treat the health consequences of cigarette smoking. *Id.* It concluded

> "[T]he MSA adequately protect[s] the public interest. . . . [T]he economic and noneconomic benefits for New York State are substantial [and] are consistent with and advance the objectives of New York public policy as set forth in the amended complaint."

Id. at 568. Indeed, the massive flow of funds from the PMs has substantially contributed to the financial welfare of the settling States; between 1999 and 2008, New York alone received nearly $7.7 billion. As for the Escrow Statute, the New York Legislature elaborated on the state policy

behind the MSA in its findings and explained how the Escrow Statute furthers that policy:

> It is the policy of the state that financial burdens imposed on the state by cigarette smoking be borne by tobacco product manufacturers rather than by the state to the extent that such manufacturers either determine to enter into a settlement with the state or are found culpable by the courts.... It would be contrary to the policy of the state if [NPMs] could use a resulting cost advantage to derive large, short-term profits in the years before liability may arise without ensuring that the state will have an eventual source of recovery from them if they are proven to have acted culpably.

N.Y. Pub. Health Law § 1399-nn(4), (6).

I found at the preliminary injunction stage, *Freedom Holdings III,* 447 F.Supp.2d at 250, and I find again on the basis of a full and complete record, that the States intended the MSA and the Escrow and Contraband Statutes not as "naked restraints on trade," but as means of achieving important public health goals and substantial fiscal benefits. In *Freedom Holdings I,* the Court of Appeals accepted Plaintiffs' allegations as if proved, for it was reviewing a motion to dismiss pursuant to Fed.R.Civ.P. 12(b). However, Plaintiffs have failed to prove the allegations of their Complaint, and thus the foundation for the Court of Appeals' rulings does not exist. Plaintiffs have presented no credible proof that the MSA has created a cartel favoring participating cigarette manufacturers. Nor have they presented proof that the

NPMs have suffered, or are likely to suffer, any antitrust injury.

I found in *Freedom Holdings III*, and I find again, that the MSA does not "mandate[ ] or authorize[ ] conduct that necessarily constitutes a violation of the antitrust laws in all cases, or . . . place[ ] irresistible pressure on a party to violate the antitrust laws in order to comply with the statute." 447 F.Supp.2d at 251 (quoting *Rice*, 458 U.S. at 661, 102 S.Ct. 3294). The continued strength of NPMs proves as much, and the absence of financial pressure on NPMs to join the MSA confirms it. Nothing in the Escrow or Contraband Statutes mandates or authorizes "illegal conduct in all cases," an essential ingredient of a per se antitrust violation. *Id.*; *see KT & G Corp.*, 535 F.3d at 1132-33; *Tritent Int'l Corp. v. Kentucky*, 467 F.3d 547, 557 (6th Cir.2006) (analyzing *Freedom Holdings I* and finding Kentucky statutes implementing the MSA not preempted by Sherman Act). The analogy to per se violations of the antitrust laws does not fit, as the proofs show neither anticompetitive effect nor lack of redeeming social purpose. *See Rice*, 458 U.S. at 659 n. 5, 102 S.Ct. 3294. Therefore, adhering to my findings and conclusions of law in *Freedom Holdings III* respecting Plaintiffs' antitrust claims, I hold that Plaintiffs have failed to establish that the MSA's terms, along with those of the Escrow and Contraband Statutes, constitute a per se violation of § 1 of the Sherman Act.

2. *Parker State Action Immunity*

Because I find no per se antitrust violation, I need not address whether New York's legislation

is preempted by federal antitrust law. *See Parker*, 317 U.S. at 341, 63 S.Ct. 307 (holding that a court must find that a state is guilty of a per se antitrust violation before evaluating whether redemptive purpose exempts it from application of federal antitrust law); *see also Rice*, 458 U.S. at 662 n. 9, 102 S.Ct. 3294. However, I assume for purposes of *Parker* analysis that Plaintiffs have proved a per se violation, *see Freedom Holdings I*, 357 F.3d at 226, and I will proceed on that assumption to analyze each prong of the *Midcal-Parker* test. *See Cal. Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. 97, 100 S.Ct. 937, 63 L.Ed.2d 233 (1980). This test provides that a state statute is exempt from antitrust preemption if "(i) the restraint in question is 'clearly articulated and affirmatively expressed as state policy,' and (ii) the policy is 'actively supervised' by the state itself." *Freedom Holdings I*, 357 F.3d at 205 (quoting *Midcal*, 445 U.S. at 105, 100 S.Ct. 937). The Court of Appeals, assuming Plaintiffs' allegations as proved, held that the Escrow and Contraband Statutes do not qualify for *Parker* immunity because New York fails to satisfy both the "articulation" and "supervision" prongs. *Id.* at 226-32. It suggested, however, that failure to satisfy the first prong would not by itself preclude immunity, thus focusing the inquiry on whether New York actively supervises the workings of the MSA. *Freedom Holdings II*, 363 F.3d at 156.

The proofs make clear that New York satisfies both prongs. As I found in *Freedom Holdings III*, and as I find again, New York has clearly articulated its reasons for entering into the MSA and how the MSA's features advance its goals, and

New York, through the yearly reporting mechanisms required by the MSA and the neutral analysis and reporting functions performed by PricewaterhouseCoopers, has actively supervised the MSA to assure that it continues to achieve its purposes without anticompetitive consequences.

Midcal requires, as its first prong, that New York "act in furtherance of legitimate state policy goals and [that] its acts must have a plausible nexus to those goals." *Freedom Holdings II*, 363 F.3d at 156. On the basis of the pleadings, the Court of Appeals held that New York had not explained how the provisions of the MSA, such as those linking OPM payment obligations to their market shares, actually further the public health. *Freedom Holdings I*, 357 F.3d at 229-30. The proofs make clear, however, that which the Court of Appeals failed to find. Because of higher cigarette prices, provoked by the substantial payments made by the cigarette companies to the States, cigarette sales have fallen by 24%, from 484.5 billion cigarettes in 1997 to 365.8 billion cigarettes in 2007. The 97.1% oligopoly enjoyed by the four major cigarette companies that were the OPMs in 1997 has been reduced to 85.9% in 2007, and smaller cigarette companies have entered and thrived in the market. New York alone, of the forty-six states that settled with the cigarette companies, has received nearly $7.7 billion from the PMs, and the potential for more from the many escrow accounts created for NPMs. In short, the purposes endorsed by the New York Supreme Court have come to pass. *See New York v. Philip Morris*, 686 N.Y.S.2d at 568. The MSA has brought about a substantial reduction in cigarette

consumption and substantial reimbursements to the States for the public costs of cigarette consumption, all without adversely impacting non-participating manufacturers. New York has ensured, by implementing legislation pursuant to the MSA, that these beneficial achievements are not corrupted by allowing NPMs to sell cigarettes at prices unburdened by any payment obligation, and potentially to dodge liability by closing up shop and selling elsewhere. As I held in *Freedom Holdings III*, 447 F.Supp.2d at 260-61, New York has articulated reasonable goals, linked to its public health needs, and its redeeming public purpose is inconsistent with a finding of a per se antitrust violation.

Likewise, the proofs show "active supervision" by New York sufficient to meet the second *Midcal* prong. The MSA provides for an auditing mechanism that requires PricewaterhouseCoopers to collect statistical information about cigarette manufacturer sales, costs, and market share and to report that information to the States and the public. Through this data, New York has closely tracked the actual workings of the MSA, including the competitive effects of the MSA regime. New York has also conducted detailed oversight through capturing the data produced by the Contraband Statute of all NPM sales in New York. *See* N.Y. Tax Law §§ 480-b, 481(1)(c), 1846.

By this statistical oversight, New York has satisfied the requirements for *Parker* immunity. Since the statistics make clear that the MSA has not proven to be anticompetitive, there has been no requirement that New York intervene to prevent a cartelization of the market. Nor has there

been any indication of price collusion, for, as all the NPM witnesses testified, cigarette pricing is autonomously and independently made, with higher than necessary pricing by the majors creating opportunities for smaller, independent cigarette sellers. Unlike the statute challenged in *Midcal,* which involved explicit price-fixing, *see Midcal,* 445 U.S. at 100-01, 100 S.Ct. 937, the statutes challenged here have not interfered with competition. The MSA has served legitimate health and welfare objectives without handicapping NPMs or creating any anticompetitive effects. Accordingly, I find that New York has satisfied both prongs of the *Midcal-Parker* state action immunity test.

D. *The Injunction Against the Allocable Share Release Amendment*

In *Freedom Holdings III,* I preliminarily enjoined New York from enforcing an amendment to the Allocable Share Release provision of its Escrow Statute. 447 F.Supp.2d at 264-65; *see* N.Y. Pub. Health Law § 1399-pp, as amended, 2003 N.Y. Laws 666, eff. Oct. 15, 2003. Informed by further briefing and evidence, I now deny Plaintiffs' request for a permanent injunction and dissolve the preliminary injunction.

Under the MSA, New York's allocable share, in relation to all other States that settled with the OPMs, is about 12.76%. New York receives that proportion of funds paid by all PMs annually. In contrast, New York receives a fixed amount from NPMs making escrow payments under its Escrow Statute, $0.0188482 (in 2007 and subsequent years) for each cigarette actually sold, or imported

into, the State. N.Y. Pub. Health Law § 1399-pp(2)(a)(v). However, because of the Allocable Share Release provision ("ASR"), § 1399-pp(2)(b)(ii), NPMs are entitled to a credit to the extent that the funds paid into escrow exceed New York's allocable share of all escrow payments made by the NPM into the escrows of all States. The ASR thus allows an NPM that concentrates its sales in one or a few states to offset by credit most of its escrow obligations, gaining a major competitive advantage over the OPMs and other PMs that market nationally.[16]

The OPMs complained of this undue competitive advantage, and sought refund or credit against their payments, invoking the NPM Adjustment provisions of the MSA. As described above, those provisions reduce the payments due by PMs by three times the amount of market share loss over 2%, if the PMs prove a collective loss of market share to NPMs, that the MSA was a "significant factor" in that loss, and that the State in issue failed to enact or diligently enforce an Escrow Statute. MSA Art. IX(d). An independent study conducted by The Brattle Group found in favor of the OPMs, concluding that "MSA disadvantages were a significant factor contributing to the Market Share Loss in 2005," as well as in prior years. Pl. Exh. 362, ¶ 228. The States nonetheless maintained that no NPM Adjustment was appropriate because the States had effectively legislated to prevent the NPMs from undercutting the MSA.

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[16] Kevin Altman, who worked for two NPMs, testified that NPMs receive their credit very soon after they make their payment into escrow Tr 24.

One such preventative measure was an amendment to the Escrow Statutes intended to prevent NPMs from abusing ASRs. This Allocable Share Release amendment, also known as an ASR repealer, allowed release of escrowed funds only at the close of the twenty-five year term or when necessary to pay judgments or settlements: NPMs could no longer obtain a yearly credit of funds paid into escrow to the extent that they exceed the State's allocable share.

In *Freedom Holdings III*, reacting to New York's just-passed ASR amendment, and without the benefit of the proofs discussed above and at the evidentiary hearing that I conducted, I enjoined implementation of the amendment. Without a record, I was concerned about possible effects on competition and the potential for evidence that the State or the public would suffer injury.

I am persuaded, however, by the evidence and further consideration, that my injunction should be dissolved. First, though Plaintiffs have presented evidence of the financial troubles of some regional NPMs after ASR repeals, they offer no proofs to show that, in the absence of the ASR, the MSA and Escrow and Contraband Statutes constitute a per se antitrust violation. The ASR encouraged NPMs to concentrate their sales within particular States, and thereby to defeat the Escrow and Contraband provisions of those States' laws. The ASR repeal has canceled that encouragement, leading NPMs in some instances to engage in "state-shifting" by refocusing their sales to States yet to repeal their ASRs, and then to the Internet and Indian reservations, where sales are not subject to escrow payments. *See* Tr. 97-102,

364-65. The ASR repeals have reduced the degree of competitive advantage enjoyed by NPMs due to the MSA. *See* Pl. Exh. 362, ¶¶ 83-87. But Plaintiffs have not shown that the MSA without the ASR disables them from competing in the cigarette market. With or without the ASR, NPMs enjoy pricing autonomy and need not follow price hikes by OPMs, particularly price hikes that overcompensate for the MSA payment burdens. *See Xcaliber Int'l Ltd. v. Edmondson,* No. 04-CV-0922-CVE-PJC, 2005 WL 3766933, at *2 (N.D.Okla. Aug. 31, 2005) ("[A]ll cigarette manufacturers, even under the cost constraints imposed by the MSA and the Allocable Share Amendment, have choices as to price and output, and . . . make their decisions as to these issues unilaterally."); *see also Int'l Tobacco Partners, Ltd. v. Beebe,* 420 F.Supp.2d 989, 997 (W.D.Ark.2006). With or without the ASR, NPMs have ample incentive to compete for market share and ample opportunity to do so, as their escrow payments, even if unrecoverable in the short term, are no more debilitating than the corresponding payments required of PMs. With or without the ASR, NPMs pay less per carton under the Escrow Statutes than the OPMs and non-grandfathered SPMs pay, and less per carton than the grandfathered SPMs pay for each marginal carton produced above their grandfathered thresholds. Just as Plaintiffs fail to show that NPMs suffer a special hardship compared to other manufacturers under the MSA as originally conceived, they fail to show that NPMs will suffer a special hardship under an MSA that denies them the ASR's yearly recovery of funds. *See KT & G Corp.*, 535 F.3d at 1128-29.

Second, the ASR amendment furthers New York's aims in signing the MSA by protecting the State against the impact on public health costs of a disproportionate inundation of cigarette sales within the State. The public welfare purpose of the MSA is enhanced by repealing the ASR, which discourages NPMs from concentrating sales in particular States at the expense of the public health and welfare of such States, and ensures that such States, including New York, are compensated for every cigarette sold in the State. With my preliminary injunction in place, New York retains in escrow only 12.76% of any individual NPM's per-cigarette payments, regardless of whether that NPM sells 12.76%, 50%, or 100% of its cigarettes in New York. Likewise, with the injunction in place, New York is assured compensation for 12.76% of the total damage to the public health caused by that NPM, regardless of whether that NPM caused 12.76%, 50%, or 100% of its total damage in New York. The injunction creates an incentive for cigarette manufacturers to disseminate their product and its ruinous consequences within the State while recompensing the State's citizens only incompletely for the injury they sustain. By dissolving the preliminary injunction, I allow New York to join the vast majority of other States that have removed the ASR from their Escrow Statutes so as better to fulfill the purposes of the litigation that the MSA resolved.

The Centers for Disease Control and Prevention estimates that, in 2002, New York incurred $149.70 per carton in productivity costs related to smoking, as well as $57.00 per carton in cigarette-

related Medicaid costs.[17] The ASR amendment requires all NPMs to pay their fair share of these costs without hindering them competitively against the PMs. Accordingly, I find by a preponderance of the credible evidence that, even after repeal of New York's Allocable Share Release provision, the MSA and Escrow and Contraband Statutes do not constitute a per se violation of the Sherman Act. No permanent injunction is justified, and the preliminary injunction is dissolved.

E. *Commerce Clause Claim*

The Commerce Clause empowers Congress to "regulate Commerce ... among the several States." U.S. Const. art. I, § 8, cl. 3. In its "dormant application," it limits "a state's power to take actions impacting interstate commerce." *Freedom Holdings I,* 357 F.3d at 216. The Commerce Clause limits state regulatory power in three ways. First, a state law is per se invalid if it clearly discriminates against interstate commerce in favor of intrastate commerce. *Id.* Second, under the " *Pike* balancing test," a state law is invalid if it is nondiscriminatory but "imposes a burden on interstate commerce incommensurate with the local benefits secured." *Id.* (quoting *Nat'l Elec. Mfrs. Ass'n v. Sorrell,* 272 F.3d 104, 108 (2d Cir.2001)); *see Pike v. Bruce Church, Inc.,* 397 U.S. 137, 142, 90 S.Ct. 844, 25 L.Ed.2d 174 (1970).

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[17] Polishook Decl , Exh G, at 11 Because these figures suggest that cigarettes represent a per-stick net drain on the public fisc, they undercut the notion that New York's "goals of serving public health and enhancing revenue conflict." *Contra Freedom Holdings I,* 357 F.3d at 230.

Third, a state law is invalid if it has the "practical effect" of controlling commerce occurring entirely outside the state's borders. *Freedom Holdings I*, 357 F.3d at 216 (citing *Healy v. The Beer Inst.*, 491 U.S. 324, 336, 109 S.Ct. 2491, 105 L.Ed.2d 275 (1989)). However, a state law is not invalid under the Commerce Clause if its only out-of-state impact is to elevate the price of goods in interstate commerce. *Id.* at 220 (noting that "upstream pricing impact" alone does not violate Commerce Clause).

In *Freedom Holdings I*, the Court of Appeals rejected all of Plaintiffs' arguments that the Contraband Statutes implementing the MSA violate the dormant Commerce Clause. It held that Plaintiffs had failed to show that the Contraband Statutes have a "disparate impact on interstate commerce," as required by both the discrimination and *Pike* balancing test theories. *Id.* at 218. Likewise, under the extraterritoriality analysis, the Court held that Plaintiffs had failed to show that the Contraband Statutes "regulat[e] commerce occurring wholly outside the borders of New York" or have the "practical effect of control[ing] conduct beyond the boundaries of the State." *Id.* at 219. The Court found that the Commerce Clause, which "protects against inconsistent legislation arising from the projection of one state regulatory regime into the jurisdiction of another State," *id.* at 220 (quoting *Healy*, 491 U.S. at 337, 109 S.Ct. 2491), had no reason to protect against the MSA, "a universal and practically uniform national system of payments by tobacco companies to states." *Id.* at 220 n. 13. Plaintiffs argued that the Contraband Statutes regulate out-of-state commerce by fos-

tering "artificially high prices" in the chain of distribution of cigarettes destined for New York, but the Court of Appeals found that effect to be "no more than the upstream pricing impact of a state regulation," noting that "out-of-state actors . . . remain free to conduct commerce on their own terms, without either scrutiny or control by New York State." *Id.* at 220-21. The Court of Appeals observed, from the relevant Supreme Court precedents, that the Dormant Commerce Clause was offended by state statutes that purported specifically to regulate out-of-state pricing decisions, or in-state pricing decisions that were required to relate to out-of-state prices. *Id.* at 221; *see Healy*, 491 U.S. at 326, 109 S.Ct. 2491 (statute requiring seller to certify that in-state prices are no higher than any out-of-state prices); *Brown-Forman Distillers Corp. v. N.Y. State Liquor Auth.*, 476 U.S. 573, 575-76, 106 S.Ct. 2080, 90 L.Ed.2d 552 (1986) (statute forbidding distiller to change out-of-state prices after posting in-state price); *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 55 S.Ct. 497, 79 L.Ed. 1032 (1935) (statute banning resale of out-of-state milk purchased at price below in-state minimum price). By contrast, the Escrow and Contraband Statutes set no particular price for instate sales and mandate no relationship whatever between in-state and out-of-state cigarette prices.

I allowed Plaintiffs to amend the Complaint to reassert a Commerce Clause claim in light of *Grand River Enters. Six Nations, Ltd. v. Pryor*, 425 F.3d 158 (2d Cir.2005), which the Court of Appeals decided one year after *Freedom Holdings I.* In *Grand River*, the Court, ruling on the

allegations of the complaint and not on the proofs, reversed the District Court and ordered that the plaintiffs could lawfully claim that the Escrow Statutes "limit, burden and regulate directly interstate commerce wholly outside the respective states." *Id.* at 170 (citations omitted). The Court noted that, while the *Freedom Holdings I* complaint had identified as an extraterritorial effect price increases in the distribution chain of cigarettes sold to New York retailers, the *Grand River* complaint more broadly alleged a "uniform system of regulation that results in higher prices nationwide." *Id.* at 171. The Court of Appeals ruled that the plaintiffs had "successfully stated a possible claim that the practical effect of the challenged statutes and the MSA is to control prices outside of the enacting States by tying both the SPM settlement and NPM escrow payments to national market share, which in turn affects interstate pricing decisions." *Id.* at 173. In so holding, the Court stressed that it "[took] no position as to the ultimate viability of the dormant commerce clause claim," having accepted as true the facts alleged in the complaint and drawn all reasonable inferences in favor of the plaintiffs. *Id.*

On remand, the District Court denied the plaintiffs' request for a preliminary injunction, finding that they were not likely to succeed on any of their claims, including the dormant Commerce Clause claim. *Grand River Enters. Six Nations, Ltd. v. Pryor,* No. 02 Civ. 5068(JFK), 2006 WL 1517603, at *8-*10 (S.D.N.Y. May 31, 2006) ("Even if . . . the amount of an escrow refund 'is, in part, keyed to the amount an NPM would have paid if it had joined the MSA as an SPM[,]' . . . Grand River has

not shown that this scheme may result in interstate price control.") (quoting *Grand River*, 425 F.3d at 172). Distinguishing the MSA and its implementing statutes from those defeated in price-parity cases like *Healy* and *Brown-Forman*, Judge Keenan emphasized that the New York legislation "neither makes cigarette prices or escrow payments in a particular State dependent on prices or escrow payments in other States, nor does it have any effect on price or escrow payments by NPMs in other states." *Id.* at *9; *see also Int'l Tobacco Partners v. Kline*, 475 F.Supp.2d at 1089-92.

In the instant case, Plaintiffs, having copied the *Grand River* complaint, allege that the statutes implementing the MSA were intended to create, and have created, a uniform system of regulation that has resulted in higher prices nationwide for domestic cigarettes. Second Suppl. & Am. Compl. ¶¶ 97-102. They argue that New York's Escrow Statute controls out-of-state cigarette prices because the escrow payment that an NPM makes to New York depends, in part, on what the NPM would owe New York as an SPM, which depends in turn on the national market shares of the SPMs, which derive in part from the pricing of cigarettes sold outside New York. Plaintiffs reason that the MSA and New York Escrow and Contraband Statutes therefore violate the principle of *Healy* and are invalid under the dormant Commerce Clause.

In *Healy*, the Supreme Court reaffirmed its "established view that a state law that has the 'practical effect' of regulating commerce occurring wholly outside that State's borders is invalid

under the Commerce Clause." 491 U.S. at 332, 109 S.Ct. 2491 (quotations omitted); *see Freedom Holdings I*, 357 F.3d at 219. The price affirmation statute in *Healy* required retailers to affirm that their in-state prices were no higher than prices charged in any other state, thereby imposing in-state consequences for out-of-state commercial decisions. The statute's practical effect was to project one state's regulatory regime into other states:

> The short-circuiting of normal pricing decisions based on local conditions would be carried to a national scale if a significant group of States enacted contemporaneous affirmation statutes that linked in-state prices to the lowest price in any State in the country. This kind of potential regional and even national regulation of the pricing mechanism for goods is reserved by the Commerce Clause to the Federal Government and may not be accomplished piecemeal through the extraterritorial reach of individual state statutes.

Healy, 491 U.S. at 340, 109 S.Ct. 2491. Discussing *Healy* in *Freedom Holdings I*, the Court of Appeals warned that it invalidates only "regulation" or "control" of out-of-state commerce. Mere "upstream pricing impact" is not a violation of the dormant Commerce Clause, even if the impact is felt out-of-state where the stream originates. *Freedom Holdings I*, 357 F.3d at 220.

Plaintiffs in this case show no more than upstream pricing impact, if that. There has been no showing that mandated escrow payments by NPMs in New York affect the retail price of

cigarettes elsewhere in the nation. NPMs make escrow payments in New York as security to satisfy judgments or settlements in litigation with New York. The Allocable Share Release provision does nothing to regulate, restrict, or control out-of-state behavior of NPMs or SPMs. "Each NPM or SPM must make its own unilateral decision with respect to price and output, and no state agent has the power to dictate the prices or outputs of any cigarette manufacturer." *Grand River,* 2006 WL 1517603 at *9.[18] The phenomenon of a nationwide increase in cigarette prices following the advent of the MSA resulted, not from the "extraterritorial reach" of any one State's statute, but because many States enacted similar statutes.[19] *See Healy,* 491 U.S. at 332, 109 S.Ct. 2491. New York exerts no control, actual or "practical," over the price of cigarettes in any other State. *See id.*

As the Court of Appeals held in *Freedom Holdings I,* Plaintiffs must show more than the fact that New York's legislation indirectly affects out-of-state cigarette prices. They must show that

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[18] NPM witnesses in this case testified to the same effect, that their prices were set internally and not dictated by OPM or SPM prices Tr. 87-88, 109-10

[19] One commentator suggests that the coordinated, nationally-oriented character of state action resulting from the MSA might raise constitutional concerns under the Interstate Compact Clause, U.S. Const. art I § 10, cl. 3, *see generally* Michael S Greve, *Compacts, Cartels, and Congressional Consent,* 68 Mo L Rev. 285 (2003) The claim is not before me, and at least one court of appeals has rejected it *See Star Scientific, Inc. v. Beales,* 278 F.3d 339, 360 (4th Cir.2002).

commercial actors outside New York are bound in some way by the dictates of New York statutes. *Freedom Holdings I*, 357 F.3d at 221. Because they have not made such a showing, I hold that Plaintiffs have failed to prove that the MSA and Escrow and Contraband Statutes are invalid under the dormant Commerce Clause.

V. *Conclusion*

Plaintiffs have shown no injury to their business or property, actual or threatened. They have failed to show that the Master Settlement Agreement and the Escrow and Contraband Statutes of New York are anticompetitive under the Sherman Act or invalid under the Commerce Clause of the U.S. Constitution, either before or after the Allocable Share Release amendment. The preliminary injunction against enforcement of New York's Allocable Share Release amendment is dissolved.

The Clerk shall terminate the motions (Docs. # 144 & # 160) and enter judgment for Defendants.

SO ORDERED.